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STRATEGY FOR FINANCING MICRO AND SMALL ENTERPRISES (MSE) ON THE BASIS OF PROFIT AND LOSS SHARING (PLS) PRINCIPLES

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CHAPTER 1. INTRODUCTION

SECTION 1.1 BACKGROUND

Japanese financial institutions are making a late entry into the Islamic financial world compared with Western counterparts; nonetheless, they appear to be warming up rapidly. Professor Koji Muto of Ritsumeikan Asia Pacific University, who specializes in Islamic economics and the economic development of the Middle East thinks that from consumer's viewpoint, Islamic finance represents curiosity about the concept and its structure (Islamic Finance Asia: 2008).

Nowadays attention to Islamic Finance is rapidly growing throughout the world. During the past decades Islamic financial institutions (IFI) expended geographically as well as proportionally in respect to the overall financial industry. The Islamic Banks are providing various types of financial services to meet the business as well as personal needs of the people around the world.

The international attention significantly grew due to the fact that IFIs maintained their positions in better condition then conventional institutions after financial crisis of 2008s'. In fact, the number of IFIs growing constantly even in non Islamic countries (The Banker/2009). Among non-Islamic countries, the UK is a leader, holding 8th positions in the countries ranking by amount of Shariah[1] compliant assets (SCA) taking the lead over countries like Turkey, Egypt, Indonesia, Brunei and others. Switzerland, Singapore and Thailand are holding 20th, 24th and 25th positions respectively.

As an industry, the Shariah-compliant assets of financial institutions (FI) rose by 28.6% in 2009 according to The Banker's 2009 survey[2], to \$822bn from \$639bn in 2008. Islamic finance as an industry has a compound annual growth rate of 27.86% (2006 to 2009) and is estimated to hit \$1033bn in 2010. Number of registered institutions reached 614 in 2008, compared with 524 the year before. The key developments in Islamic finance over the past year have been the growth in new institutions, especially Islamic investment banks, in the Gulf and also in London. Some large FIs like European Finance House and Gatehouse Bank, based in London are seriously getting involved in Islamic financial operations. HSBC Amanah, the Islamic subsidiary of global giant

[1] The code of law derived from the Qur'an and from the teachings and example of Mohammed (s.a.a.w.)
[2] November 2009 supplement survey, incorporating 500 Islamic institutions, including banks, finance companies and insurance companies from 47 countries.

HSBC, has jumped to 10th place in *The Banker*'s table, from 14th in 2007, after a significant 56.2% rise in SCAs.

Nevertheless, Islamic finance in support of micro and small enterprises (MSE) still remains in its earliest stage of development. Despite the fact that only some Islamic banks and other microfinance institutions (MFI) are already piloting microfinancing projects, there is a serious need in effective loan products and appropriate schemes of implementation of MSE financing products. Moreover, there is an opportunity for financial organizations to grow their loan portfolio since many people waive to receive conventional loans because of their religious beliefs. Patrick Honohan's finds that in the Islamic Development Bank's 56 member countries, only 28 percent of the adult population uses formal or semi-formal financial intermediaries, whether through deposit accounts or borrowing. This percentage includes non-Muslims living in such countries. At the same time, even when financial services are available, some people view conventional products as incompatible with the financial principles set forth in Islamic law. Islamic Banks and Islamic subsidiaries of conventional banks became the target for criticism by some Islamic Scholars and other observers for not being Shariah compliant.

In a 2007 global survey on Islamic microfinance, CGAP collected information on over 125 institutions and contacted experts from 19 Muslim countries. The survey and a synthesis of other available data revealed that Islamic microfinance has a total estimated global outreach of only 380,000 customers and accounts for only an estimated one-half of one percent of total microfinance outreach. The supply of Islamic MSE finance is very concentrated in a few countries, with the top three countries (Indonesia, Bangladesh, and Afghanistan) accounting for 80 percent of global outreach. Nevertheless, demand for Islamic MSE finance products is strong. Surveys in Jordan, Algeria, and Syria, for example, revealed that 20–40 percent of respondents cite religious reasons for not accessing conventional microloans. (Nimrah K, et al.: 2008)

SECTION 1.2 RESEARCH FOCUS

John Sandwick[1], an Islamic asset management consultant says “While many banks have dedicated time and resources into developing products for Shariah or Islamic law-conscious investors, the available product range remains woefully inadequate”. (Emirates Business/2009) "The demand is there, but we need products, products, products," (Reuters/2009).

Academics, observers and other interested parties publishing their work papers on results of their observations are pointing or sometimes criticizing Islamic-financial services providers for their products. One of the most active observers of Islamic Microfinance industry Professor of Rice University Mahmoud El-Gamal[2] hinting that the word “Islamic” became something like new brand for Banks in order to attract religious people. In his 2010 year publication “Islamic Banking Needs Restructuring” Mr. M.Iqbal Patel chartered accountant of Karachi says that most of the Islamic banks are operating parallel to conventional banking. They have adopted the mode of financing on fixed rate of return basis and not on profit and loss share basis (PLS) while PLS is the one of main principles of Islamic finance.

Despite so much research and theoretical work done into the Islamic Economics, there is a lack of practical products and implementation schemes to develop Islamic microfinance. Many experts agree that main part of Islamic financial operations is related to operations with Islamic securities. However, commercial banking or sometimes referred as “business banking” calls for more innovation to develop Shariah driven financial products to cater private business of all types. There is a strong need in effective loan products which will respond to Shariah and will be beneficial for both MSE’s and Banks.

SECTION 1.3 OVERALL RESEARCH AIM AND INDIVIDUAL RESEARCH OBJECTIVES

Before starting introduction to the *Overall Research Aim* and *Individual Research Objectives*, let us begin with small enlightenment to the two categories of Islamic financial operations. One of best Islamic finance exerts Mr. Adiwarman (2005) distinguishes Islamic banking operations into *natural certainty contracts* and *natural uncertainty contracts.* Former category of contracts involves

[1] One of the most active innovators in Islamic banking, having created several first-ever investment products.
[2] Operates own blog dedicated for Islamic Economics. http://elgamal.blogspot.com/

financial operations where bank is able to predict cash flow with relative certainty, for both its amount and timing. As a rule, these operations are not based on PLS principle and mostly include financing of “sale and purchase contracts”, leasing contracts and other types of debt financing contracts. Most or even all (for some institutions) of the financial products and services provided in Islamic retail banking are under this category. Simply because, since these are relatively certainty contracts, are less risky. But the financial products under *natural uncertainty contracts* are based on PLS principle and therefore are more risky. Only few institutions provide financial products and services for this type of contracts. At this moment, it is evident that Islamic banks need good and practical products to be able to invest to MSE and in this way support private business sector. With this understanding, introduction to present section continues.

The overall aim of this research is to advance in development of a **model for implementation of MSE financing products that are based on PLS principles**. Please see note-1[1].

The following objectives have been identified of paramount importance in helping to achieve the aforementioned aim:

1. *Identify the basics and main principles of Islamic finance, particularly scope of issues concerning “lending/borrowing money”.*
2. *Evaluate critically MSE financing products provided by IFIs and identify the very points needed in improvement.*
3. *Analyze conventional MSE financing techniques and recognize potential tools and analysis methods for adopting into Islamic microfinance.*

Please see note-2[2].

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[1] ***Why the term MSE finance used instead of Microfinance?*** *In order to make distinction from established perception of the term Microfinance - as poverty alleviation instrument. The purpose of our model includes but not limited with financing the poor people only, but any type of small business regardless of the owner’s financial situation or any other status in society. If, in places the term Microfinance is used, the research does not make distinction in meaning from MSE finance.*

[2] ***Initially, the main aim of the research was slightly different.*** *It was to create Islamic financial product to support MSEs, and accordingly to this aim the objectives were also different. However later on, after accomplishment of qualitative research, the main aim and objectives of the research slightly has changed as it is now. Section 4.3.1 of Chapter 4 describes the reason of such transformation.*

1st objective will cover some historical information about Islamic Economics, particularly when and according to which source of knowledge Muslim people started build their business relations. More importantly, this objective will concentrate on investigation of types of business agreements and financial operations in order to recognize the primary goal of such system.

When I came up with the idea of developing Islamic MSE finance model, I knew that to accomplish this task perfectly, it is important to see the real operation in practice. It is important because to refine something into better condition the current condition needs to be learned. Unfortunately, my several-month endeavors to undertake some research work in one of Islamic banks did not give positive result as nobody accepted my entreaty. Nevertheless, to fulfill the 2nd objective, all the needed information will be collected through interview with specialist of Islamic Bank and by analysing the documentations in practice used by IFIs today.

Within the 3rd objective the research will concentrate on finding, analysis and assessment of conventional MSE finance model that proved to be very successful and effective. This part of research will be based on secondary source and some related data will be collected through interviews with experts working in conventional MSE financing industry.

SECTION 1.4 VALUE OF THIS RESEARCH

Before determining the value of this research, let us briefly make second small enlightenment to the Islamic finance.

Islamic finance differs with some principles that prohibit practices considered unfair or exploitative. The most widely known characteristic of the Islamic financial system is the strict prohibition on giving or receiving any fixed, predetermined rate of return on financial transactions. This ban on interest, agreed upon by a majority of Islamic scholars, is derived from two fundamental Sharia precepts: 1st, money has no intrinsic worth and not an asset by itself and can increase in value only if it joins other resources to undertake productive activity. 2nd, providers of funds must share the risk of the business. They are not considered as creditors - who are typically guaranteed a predetermined rate of return, but rather investors - who share the rewards as well as risks associated with their investment. (Nimrah K, et al.: 2008)

The criticism addressed to “some” banks for the use of word “Islamic” is not for no-reason. But, unfortunately those critics are not providing the solutions to improve the situation. Banks are not so willing actually to launch products for financing *natural uncertainty contracts* only because of the high risk. The research is valuable firstly because it will help to advance the Islamic MSE finance operations with *natural uncertainty contracts.* It is beneficial for banks because there is potential market; and, for entrepreneurs to fulfill their financial needs. As it was mentioned before, many of entrepreneurs reject interest based loans referring to religious believes.

This research is looking at issue from a different angle, not from the banks’ part nether a borrowers’. But more likely from the point of view of Consultant that understands the situation and eager to provide solution advantageous for both. In the larger scale, the final “product” of the research is devoted not only to IFIs since it could be assessed just as an alternative method of financing MSEs, and applied in different parts of the worlds.

Upon finishing the dissertation, the developed model of implementation of MSE financing will be sent to the Islamic Development Bank and other conventional/nonconventional MFIs that are involved in any types of small business financing projects, including both conventional and Islamic institutions.

CHAPTER 2. LIMITATIONS AND DATA COLLECTION METHOD

As it is stated in the previous chapter the overall aim of the research is development of a **model for implementation of MSE financing products that are based on PLS principles.** In order to reach aim, following objectives are determined to be fulfilled:

1. *Identify the basics and main principles of Islamic finance, particularly scope of issues concerning lending/borrowing money.*
2. *Evaluate critically MSE financing products provided by IFIs and identify the very points needed in improvement*
3. *Analyze conventional MSE financing techniques and recognize potential tools and analysis methods for adopting into Islamic microfinance.*

SECTION 2.1 LIMITATIONS

There are cases when in interpreting Islamic financial terminologies the opinions of Islamic Scholars vary. One expert may have own view on issue while another slightly different. It goes without saying that I am not the one who will provide the most correct determinations, simply because I am not the expert in Islamic economics and its legislation. Therefore, in providing support for views, the research mainly will rely on internationally accepted experts, who have large experience in relevant subjects and have important positions in different organisations.

One may ask why the objectives are not intended to deeply insight to Islamic Economics, but determining only the basics and principles of Islamic Finance. As it is stated earlier, overall research aim is to develop a practical model for implementation of financing product based on PLS principles. Certainly, the research is about Islamic finance, but Islamic economics is really huge area of investigation that takes years to study. Therefore the insight area into Islamic finance will be limited with findings on basic principles of Islamic finance and main Islamic instruments used for extending loans for *natural uncertainty contracts*.

As it is mentioned in section-1.3, in spite of several month of endeavor to undertake internship in IFI I could not realize the goal since nobody accepted my entreaty. Nevertheless the information on nowadays issues will be collected through interview with specialist of Islamic Banks and by analysing the reports published by IFIs.

Another thing is to note about model for MSE finance is that, although it could be used for promoting microfinance industry, the model is not strictly a mean for poverty alleviation purpose. Therefore, the research will not present any information related to the level of poverty in the world/Islamic world, or any other data related to the poverty alleviation issues.

SECTION 2.2 OBJECTIVE 1

Identify the basics and main principles of Islamic finance, particularly scope of issues concerning lending/borrowing money.

In learning basics and principle of Islamic finance the research mostly relies on secondary data. For learning the theory of Islamic finance from the primary source means one should be able to read Arabic, therefore the secondary source is unavoidable choice. There are plenty of English publications from leading Shariah scholars who possess knowledge in relevant financial subjects including Islamic Economics as well.

SECTION 2.3 OBJECTIVE 2

Evaluate critically MSE financing products provided by IFIs and identify the very points needed in improvement.

Achievement of objective 2 will be based on two sources. First is secondary data analysis which is literature review. The literature includes not only the theoretical publications but also reports published by institutions like Islamic Development bank, Islamic Research and Training Institute and some data published on official w-sites of Islamic Banks. Second source is interview wich conducted with professionals from both Islamic institutions and conventional institutions.

SECTION 2.4 OBJECTIVE 3

Analyze conventional MSE financing techniques and recognize potential tools and analysis methods for adopting into Islamic microfinance.

To achieve objective 3, the research uses the same sources as in objective 2. Objective 3 includes investigation into SME financing model being used in real practice by banks in real time. The investigation into practical models will include overall cycle of operations starting from finding potential borrowers ending to repayment of the loan.

SECTION 2.5 REACHING THE AIM

The fulfillment of all three objectives will mean that the existence of problem is proved, the source of the problem is determined, and proposal for solution of the problem is defined.

After objectives are achieved, the research will propose the model for implementation of MSE financing products that are based on PLS principles. It will be something like manual for Islamic microfinance institutions which proposes recommendation on how PLS based financial products should be implemented. Solutions for the problems will be based on my own ideas, literature review findings and comments of interviewees.

CHAPTER 3. LITERATURE REVIEW

SECTION 3.1 INTRODUCTION

How religion may be a guide in issues like borrowing and lending money? For some people these questions may sound unanswerable or maybe even inexpedient. But a Muslim who knows the religion very well can give founded answers and comments. Many people associate Islamic Finance with just disliking interest, while it has some more distinctive feature.

Islam is regarded as one of the three central faiths along with Judaism and Christianity. Islam teaches that Allah is merciful and compassionate. Pette Seda (2002) provides with following definition: Allah is an Arabic word, meaning “The one and only true deity”, the proper name of the One who created the havens and the earth. The word Islam comes from the Arabic words *salaam*, which means peace and *taslim*, which means submission. The follower of Islam is a Muslim. The word Muslim means one who submits to the will of God. This is done by declaring that "There is no god except one God and Muhammad is the messenger of God." In a broader sense, anyone who willingly submits to the will of God is a Muslim.

Muhammad ibn Abdullah (s.a.a.w.[1]) was born in a noble tribe of Mecca in Arabia in the year 570/571 AD. At age 40, he was given the prophethood and the revelations came over 23 years and were compiled in the form of a book called the Qur’an which Muslims consider as the final and the last word of God. The Qur’an has been preserved, unchanged, in its original form and confirms the truth in the Torah[2], the psalms and the Gospel[3].

Shariah in simple language is Islamic Law. It consists of general rules and principles derived mainly from the Qur'an, the Sunnah and Hadith. The Sunnah is collection of the words and acts of the Prophet Muhammad (s.a.a.w.). Hadith are narrations originating from the words and deeds of the prophet Muhammad (s.a.a.w). Both Sunnah and Hadith are regarded as important tools for understanding the Qur'an and in matters of jurisprudence. Shariah covers every aspect of daily

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[1] “*Sall Allahu alayhi wa sallam*” which is “*May Allah honour him and grant him peace*” in Arabic.

[2] Refers to the Five Books of Moses—the entirety of Judaism's founding legal and ethical religious texts.

[3] Is a writing that describes the life, death, burial, and resurrection of Jesus (p.u.h.)

individual and collective living. While all the schools of thought agree on the fundamental Shariah principles enshrined in the Qur'an, Sunnah and Hadith, they sometimes hold differing views on their interpretation and application. There are some more sources for Shariah considered as secondary sources: Qiyas, Ijma, Ijtihad.

There are 5 pillars in Islam: Faith to Allah and his messenger, the daily prayers, the fast during Ramadan, **the almsgiving** (*zakah*) and the pilgrimage to the Mecca. The almsgiving is underlined because it is related to finance and will be discussed more later on.

SECTION 3.2 DISTINGUISHING FEATURES OF ISLAMIC FINANCIAL INSTITUTIONS

Logically to conclude, that Islam is not merely a religion. It is something like SYSTEM that provides, a complete code catering for all fields of human existence, individual and social, material and moral, economic and political, legal and cultural, national and international. Islamic scholars have deduced from the Shariah three main principles which distinguish IFIs from its conventional counterpart: Prohibition of Riba; Prohibition of Gharar; and Prohibition of Maisir/Qimar.

3.2.1 Prohibition of RIBA

Islam, Christianity, and Judaism have strongly condemned and prohibited *riba*. Zakir Zamir (2007: 3) informs what Allah says in Qur’an about *riba*:

“*That which ye lay out for increase through the property of (other) people, will have no increase with Allah: But that which ye lay out for charity, seeking the countenance of Allah (will increase): it is these who will get a recompense multiplied*”. (30:39)

“*That they took riba (usury), through they were forbidden and that they devoured men’s substance wrongfully – We have prepared for those among men who reject faith a grievous punishment*.” (4:161)

Riba has been extracted from Raba. It means addition, increase. So, *riba* literally means to increase, to grow, to rise, to add, to swell. It is, however, not every increase or growth which has been prohibited by Islam. In the Shariah, *riba* technically refers to the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan (Maudoodi, abul A’la: 1987). The prohibition of *riba* is clearly the most significant principle of Islamic Finance.

Lending money should not generate unjustified income. All Muslim scholars are adamant that this prohibition extends to any and all forms of interest and that there is no difference between interest-bearing funds for the purposes of consumption or investment, since Shariah does not consider money as a commodity for exchange. Instead, money is a medium of exchange and a store of value. *Riba* can take one of two forms: *riba al-naseeyah* and *riba al-fadl*. *Riba al-naseeyah* is the amount of excess received by a lender in addition to the capital amount lent. This type of riba is comparable to the traditional concept of interest in conventional lending activities. *Riba al-fadl* is excess compensation without any form of consideration in return. In modern finance, it could be applicable to several exchanges of commodities contracts. The idea is that when compensation is paid, it should be justified or be set against a specific activity and the return should also be associated with a specific risk.

Normal question would be: How the one who has money can benefit from it? IFIs extend loans or other financial services under the principle of *Profit and Loss Sharing (PLS)*. *PLS* financing is a form of partnership, where partners share profits and losses on the basis of their capital share and effort. Unlike interest-based financing, there is no guaranteed rate of return. Islam supports the view that the people do not act as nominal creditors in any investment, but are actual partners in the business. It is comprised of equity-based financing. The justification for the *PLS*-financier's share in profit is the person’s effort and the risk he carries, since his profit would have been impossible without the investment. Similarly, if the investment has made a loss, his money would bear the loss. Shortly, if one wants to have profit, then he/she have to bear the risk.

3.2.2 Prohibition of Gharar/Khatar

Gharar means hazard, chance, stake or risk. It is the second major prohibition, which refers to the uncertainty or hazard caused by lack of clarity regarding the subject matter or the price in a contract or exchange. A sale or any other business contract which entails an element of *Gharar* is prohibited. In the legal terminology of jurists, “Gharar” is the sale of a thing which is not present at hand or the sale of a thing whose “Aqibah” (consequence) is not known or a sale involving hazard in which one does not know whether it will come to be or not. (Muhammad Ayub: 2007) In simple words it is prohibited because there is no certainty as to when a claim will be paid, given that there is no way of knowing if and when the insured event will occur.

3.2.3 Prohibition of Maisir and Qimar (games of chance)

The words *Maisir* and *Qimar* are used in the Arabic language identically. *Maisir* refers to easily available wealth or acquisition of wealth by chance, whether or not it deprives the other's right. *Qimar* means the game of chance – one gains at the cost of other; a person puts his money or a part of his wealth at stake wherein the amount of money at risk might bring huge sums of money or might be lost or damaged (Muhammad Ayub: 2007). One reference from Qur'an in this regard:

"O you who believe! intoxicants and gambling, sacrificing to stones, and divination by arrows, are abominable actions of Satan; so abstain from them, that you may prosper."(5: 90)

Gambling is a form of *Gharar* because the gambler is ignorant of the result of the gamble. A person puts his money at stake wherein the amount being risked might bring huge sums of money or might be lost or damaged. Present-day lotteries are also a kind of gambling. Islamic banks have to avoid conventional financial transactions and bank schemes or products in which *Maisir* and *Qimar* are involved. For example: Conventional insurance because it is involved to both *Riba* and *Maisir*; or, Present futures and options contracts that are settled through price differences only are covered under gambling.

In addition to abovementioned distinguishing features, all activity must be for *Halal* (permitted) purposes. It is prohibited for Muslims as well as IFIs benefit from *Haram* (prohibited) activities such as casinos, related to alcohol, related to pork, and some others. But, today it is very difficult or even impossible to fulfill this rule. Let us think about a hotel located in Malaysia, in which anytime foreign guest may order beer. Does this mean Bank cannot lend money to that hotel? If so, Islamic banks would only be able to invest in a very limited number of businesses internationally. In light of the practical considerations of international commerce and in order to enable Muslim investors to participate in it, a number of prominent *Shaiah* scholars have advanced standards and rules to allow business grow. With some conditions banks or Muslims may do business with companies involved to prohibited activities in some extent. For example the main business activity must be Halal while profit from prohibited activity must be small and not exceed determined percent in respect to overall profit. Such part of prohibited profit varies according to the level of seriousness of prohibited activity.

3.2.4 What is Zakah?

As mentioned before, almsgiving or *Zakah/Zakat* which is 1 of 5 pillars of Islam, also related to financial issues. In *Shariah* the word *Zakah* refers to the determined share of wealth prescribed by God to be redistributed among deserving categories. It is also used to mean the action of payment of this share. Scholars specialized in the financial and administrative issues of Islam look at *Zakah* as a component of its socio-financial term. (Yusuf Al Qardavi: 2005) It is the duty of an Islamic community not just to collect *Zakah* but to distribute it fairly as well. Muslim jurists agree that *Zakat* is obligatory on the Muslim who has reached puberty, who is sane, who is free, and who owns wealth above the minimum level. Consequently, the receivers of *Zakah* are the ones who own wealth below the minimum amount including those who are not able to fulfill their needs independently, for example orphans, widows, handicaps, etc. Denying *Zakat* equals denying the Islamic faith. The receiver may be anyone independently of their religion.

In simple terms, we could define *surplus wealth* as any wealth that is over and above the necessary expenses that one and ones dependants need in order to live normal day-to-day lives. The *Zakah* is paid in once a year. Generally it is 2.5 per cent of the total value of capital and profits less uncovered debts and depreciation. In agriculture the rate may vary from 5 to 10 per cent, according to the type of irrigation. As a rule, IFIs establish *Zakah* funds. (Al-Omar *et,al.,:* 1996; Warde: 2000).

SECTION 3.3 Islamic Banks

Islamic bank may be commercial bank, investment bank, or mix of both of commercial and investment banks. All the banking operations must be in line with Islamic norms. It must be profit oriented, because, just like traditional bank it must protect the depositors and give them profit for their investments. Generally, the objective is to develop the activity within and according to Islamic principles hence not engage in prohibited activities (production or trade of alcoholic beverages and pork, gambling, etc.).

Basically there are five types of Islamic Banks (Irene Bjorklund *et,al.*, 2004 cited in Al-Omar *et,al.*, 1996):

- The Islamic Development Bank
- The banks which operate in countries where the whole banking system is overseen in some way by religious bodies (ex: Pakistan)
- The Banks which operate in Muslim countries and which co-exist with interest based banks (ex: Jordan, Egypt, Malaysia)
- Islamic banks in non-Muslim countries whose monetary authorities do not recognize their Islamic character (ex; Al-Baraka International Bank in London, UK)
- Islamic banks which exist in non-Muslim countries whose monetary authorities do recognize their Islamic character (ex: Faisal International Bank in Copenhagen, Denmark)

Generally Islamic Banks receive profits from following areas: trading operations, leasing operations and from PLS sharing operations. There are different types of tools and products devised to earn profit on these transactions. At the same time both tools and transactions must conform to Shariah and fulfill its desired objectives. For all the transactions and operations in Islamic banks, there are four main principles (Irene Bjorklund *et,al.*, 2004 cited in Al-Omar *et,al.*, 1996):

- There must be some risk, weather funds are used in commercial or productive venture;
- All funds should preferably finance socially productive activity;
- Financial risk must lie solely with the lender of the capital and not with the manager or agent who works with the capital;
- Interest is forbidden in that it is a predetermined, fixed sum owed to the lender irrespective of the outcome of the business venture in which the fund is used.

Nowadays, Islamic Banks and Microfinance institutions facing new challenge at developing new financial products and instruments to deal with the problems of the Muslim communities. However, some believe that if financial products are based on Islamic principles, not only Muslim communities will benefit.

The relationship between the service provider and the customer is quite different for Islamic Financial Institutions (IFI) comparing to conventional banks. For conventional institution basically it is lender-borrower type of relationship, while for IFI it is one of direct trading or equity participation.

3.3.1 Introduction to Islamic finance instruments

Before providing insight to instruments and products used by IFIs to deal with daily operations, it is quite important to give some explanations regarding prohibition of *Riba* (interests). So, why Islam prohibits *riba?*

Considering this question, my first opinion was connected to the slavery system of past centuries. From the History class of primary education, I remember some lessons about old times when a borrower could become a slave to the lender if the former failed to repay the debt. Sometimes even lender tried to hinder the borrower's activity so that eventually he/she will become a slave. As a rule, in that way poor becomes poorer and rich richer. Comparing old times with nowadays conventional lending operations we may find some analogous episodes. Surely, conventional banks bear the risk of non-repayment, but all the security measures are fixed to protect bank's capital. And of course there are no worries about becoming a slave, but as a rule, in the case of default by the borrower, bank will withdraw funds from the pledged property. Moreover, the bank will penalize the borrower for the overdue part of interests and total amount of charged interests may even become larger than the initial principal amount. Islamic bank will never do so unless borrower does not breaches the terms of the agreement. For example the breach of the agreement could be related to carelessness of the borrower to the business or cheating, etc.

But scholars define the harm of *riba* in followings: *riba* is unfair, *riba* is exploitative and *riba* is unproductive.

1st, *riba* is unfair. In traditional lending system, borrower have chance to have all the profit while bearing all the risk to loose. Equity is another reason why the concept of interest is rejected. The rich have a surplus of money while the poor and needy are the once force to borrow. Interest can therefore be seen as rewarding the rich and penalizing the poor. (Naseer&Moutinho: 1997)

2nd, *riba* is seen as exploitative since it favours the rich with surplus of money and punishes the poor and needy who are forced to borrow. The profits and losses should be shared between the borrower and the lender. (Akacem, *et,al.*, 2002)

3rd, The issue of fairness is related to the issues of efficiency and productivity. Money should be used in economy and enhance the welfare. Abstaining from consumption, this saving money is not an act that should be rewarded. In Islam the idea of getting a return for money only deposited in a bank is unacceptable. To justify reward the savings must be turned into productive use in thereby contribute to the economy with risk-sharing as a part, according to the teachings of Islam. (Akacem, *et,al.*, 2002)

The absence of *riba* is the main distinguishing feature of IFIs and it is a basis of financing. To avoid *riba* institutions have a number of instruments and tools to do their business. For financing PLS based contracts, there are mainly two instruments named *Musharakah* and *Mudharabah* in Arabic. Also many more new techniques were introduced to meet particular needs in modern business, but since most of these are not related to the main aim of the research, there will be just introductory information on them. Basically the instruments to be used in developing our products are *Musharakah* and *Mudharabah.* These are two instruments classified as *natural uncertainty contracts* and were used by Arabs even before the introduction of Islam.

3.3.2 Musharakah

Musharakah is a word of Arabic origin which literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture. It is an ideal alternative for the interest-based financing with far reaching effects on both production and distribution. (Usmani: 1998)

In *Musharakah* capital owner finances investment in another party's business on the condition that capital owner shares the profit from the business.

"Interest" predetermines a fixed rate of return on a loan advanced by the financier irrespective of the profit earned or loss suffered by the debtor, while *Musharakah* does not envisage a fixed rate of return. Rather, the return in *Musharakah* is based on the actual profit earned by the joint venture.

The financier in an interest-bearing loan cannot suffer loss while the financier in *Musharakah* can suffer loss, if the joint venture fails to produce fruits. (Usmani: 1998) On the other hand the greater the profits of the business, the higher the rate of return to both parties. This type of joint venture is mostly oriented for limited production or some kind of long-term commercial activities, whereby the parties contribute capital as well as technical and managerial expertise in varying proportion. It can be applied either the whole business or particular part of activity within the business.

The profit-sharing ratio is predetermined and fixed and known to all concerned. The capital owner and entrepreneur agree upon the ratio and it may be different from the ratio in which the two parties have invested in the total capital of the project. The reason for this is that the two parties may share the work of managing the project in any amount mutually agreed upon. Both parties are allowed to charge a fee or wage for any management or labour put into the project. All providers of capital have the right to participate in management and audit the operations but are not required to do so. The losses are shared according to the exact proportion of the capital contribution ratio without any modification. (Irene Bjorklund *et,al*., 2004 cited in Al-Omar *et,al*., 1996)

There are some conditions to be fulfilled in order to commit real *Musharakah* contract. *Musharakah* is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc., etc. (Usmani: 1998)

3.3.3 Mudharabah

Mudharabah is a partnership arrangement in which one party provides capital to the partnership while the other party provides entrepreneurial skills. Any loss is borne by the financier; any profit is shared by the partners according to a pre-agreed ratio. (Muhammad Ayub: 2007)

Mudharabah certificates can mature at call, at fixed interval, after issue or at a fixed date. The holder of *Mudharabah* certificate is entitled to share in the profits of the investment activities being undertaking by the company. Risk capital for the company can be provided in the form of direct equity, or through loans with equity features. Agreements can be made between the two parties concerning for how long a period of time the capital can be used and if it only intended for a specific project. Once the project or the time period has ended the entrepreneur returns the money to the investor. Besides that, the investor also receives his pre-agreed share of the profit. The entrepreneur keeps what remains of the profit for himself as a compensation for his work and expertise. Should the venture be unsuccessful, the capital provider alone must bear the financial losses. The liability of the investor is limited to the amount of the capital he has paid. The entrepreneur losses his reward for the time and effort spent. But he does not have to bear any financial loss under the condition that he has not been negligent. The risk of total loss, of total loss through mismanagement or negligence, is forbidden. The entrepreneur is obliged to repay the original sum of capital to the owner in case the entrepreneur is or has been negligent. (Irene Bjorklund et,al., 2004 cited in Zineldin: 1990)

Mudharabah capital should preferably be in the form of legal tender money, because capital in the form of commodities may lead to uncertainties and disputes. The value of illiquid assets must be clearly determined in terms of legal tender at the time of entering into the *Mudharabah* contract and there should be no ambiguity or uncertainty about its value. A financier cannot give the entrepreneur two different amounts of capital with the stipulation that profit earned from one should go to him and from the other to the entrepreneur. Similarly, he cannot specify different periods to state that profit earned in a specific period will be his and that of another period, the entrepreneur's. It is also not allowed to stipulate that profit from a particular transaction should go to the financier and the profit from another transaction will belong to the entrepreneur. *Mudharabah* business can be of two types: *restricted* and *unrestricted Mudharabah.* In restricted one the finance provider specifies any particular business; the entrepreneur shall undertake business in that particular business only for items and conditions and the time set by the financier. But in the later one, entrepreneur shall be authorized to invest the funds in any business he deems fit. In both cases, the actions of the entrepreneur should be in accordance with the business customs relating to the *Mudharabah* operations: the subject matter of the contract. Both parties in *Mudharabah* are at liberty to agree on the proportion or ratio of profit-sharing between them with mutual consent. This ratio has to be decided at the time the contract is concluded. They can agree on equal sharing or allocate different proportions. A lump sum amount as a profit/return on investment for any of the parties cannot be allowed or agreed upon. In other words, they can agree on, for example, 50, 40 or 60% of the profit going to the financier and the remaining 50, 60 or 40 %, respectively, going to the entrepreneur. Different proportions can be agreed upon for different situations. For example, the financier can say to the entrepreneur: "If you deal in wheat, you will get 50 %, but if you deal in cloth, you will be given 40% of the profit. Or if you do business in your town, you will get 40% and if in another town, your share in the profit will be 50 %." Loss, if any, has to be borne by the financier. Loss means erosion of capital; no profit can be recognized or claimed unless the capital of *Mudharabah* is maintained intact. (Muhammad Ayub: 2007)

3.3.4 Musharakah distinguished from Mudharabah

Mudharabah is distinguished from *Musharakah* briefly on the following grounds:

1. The investment in *Musharakah* comes from all the partners, while in *Mudharabah*, investment comes from a person or a group of persons.
2. In *Musharakah*, all partners have a right to participate in the management of the business and can work for it, while in *Mudharabah*, the financier has no right to participate in management. With mutual consent, however, he can work for the venture.
3. In *Musharakah*, all partners share the loss according to the ratio of their investment, while in *Mudharabah*, the loss, if any, is suffered by the financier only, providing that the entrepreneur did not conducted business with negligence or has been dishonest.
4. The liability of the partners in *Musharakah* is normally unlimited. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the liabilities exceeding assets shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition. Contrary to this, in *Mudharabah*, the liability of the financier is limited to his investment unless he has permitted the entrepreneur to incur debts on his behalf.
5. In *Musharakah*, profit can be distributed on an annual, quarterly or monthly basis by valuation of the assets. In the case of *Mudharabah*, final distribution can take place only after liquidation of the

Mudharabah business. However, on account payment of profit is possible subject to ultimate adjustment.

6. In *Musharakah*, all assets of the *Musharakah* become jointly owned by all of the partners according to the proportion of their respective investment. In *Mudharabah*, however, all the goods/assets purchased by the entrepreneur are solely owned by the financier, and the entrepreneur can earn his share in the profit only if he sells the assets profitably.

3.3.5 Other modes of financing

Variety modes of financing tools were introduced in order to meet particular needs in modern business. For example one of the mostly used *"Mark-up schemes"* by Islamic banks is *Murabahah,* which is a *"cost-plus sale"*, a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit or mark-up thereon. *Ijara* which means "to give something on rent" is similar to *Leasing* while it has some distinctive features. *Salam* is a financing of a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. (Usmani: 1998) Basically, these products are targeting mostly *natural certainty contracts.*

For each type of financing tool there are specific conditions to be fulfilled according to Shariah. There are many more tools and modes of financings that are designed to satisfy market needs, But these types of financing tools are not the main target of the research.

SECTION 3.4 ROLE OF SHARIAH SCHOLARS AND SHARIAH BOARDS

3.4.1 The role of Shariah scholars

One of the key distinguishing features of Islamic finance is the role played by Shariah scholars. Shariah scholars play both an advisory and a supervisory role in Islamic finance. They are ultimately responsible for determining whether a particular transaction or product complies with Shariah law. They can do so acting individually or (as is more usually the case) acting through a Shariah board comprising two or more scholars.

There is no formal training or qualification for a person to assume the role of a Shariah scholar. However, a person must have a deep understanding and knowledge of the Qur'an, Hadith, Sunnah and Shariah law generally in order to be recognized and accepted as a Shariah scholar. This knowledge and understanding is typically acquired through studying at a traditional religious institution. Shariah scholars who are active in the Islamic finance industry tend to also have a background in economics and finance. (IDLO[1]: 2009)

3.4.2 The role of Shariah Boards

Shariah boards are typically responsible for reviewing an institution's Islamic operations, products and transactions in order to ensure that they comply with Shariah law.

The scope of the role undertaken by a Shariah board varies from institution to institution and across jurisdictions, as most jurisdictions have yet to develop a detailed regulatory framework governing the appointment of Shariah boards, the scope of their duties or the qualifications required for someone to become a Shariah scholar. Indeed, some jurisdictions do not even require an institution offering Shariah compliant products and services to have a Shariah board. As such, most arrangements involving Shariah boards are voluntary and the scope of their involvement can range from getting involved in the operations of the institution and holding regular meetings with its management (as is the case with some traditional Islamic banks) to only being engaged on a transaction-by-transaction basis to review and approve proposed transactions or products as being Shariah compliant. Shariah scholars sitting on Shariah boards are typically commercially astute and generally have exposure to a broad range of issues through acting on several Shariah boards for various institutions. Decisions of a Shariah board, as to whether a particular transaction or product is Shariah compliant, are generally arrived at by consensus. The Shariah board will then issue a *fatwa* which is pronouncement to confirm that that transaction or product is Shariah compliant. If a single scholar has been engaged to review a transaction or product, then he will issue a *fatwa* after he is satisfied that the proposed transaction or product complies with the requirements of Shariah law. However, a *fatwa* does not ensure that the relevant transaction or product will be accepted as Shariah compliant by every Shariah scholar. In fact, there have been instances where one or more Shariah scholars have disagreed with the view taken by an institution's Shariah board. (IDLO: 2009)

[1] International Development Law Organisation

3.4.3 Getting Fatwa (approval)

It is important to bear in mind that the steps for obtaining Shariah approval will vary from institution to institution and quite possibly from transaction to transaction. For example, an Islamic bank or a conventional bank with an Islamic division or window will have a Shariah board, whereas other institutions may not have a Shariah board but may approach Shariah scholars on a transaction by transaction basis or in relation to a particular product. Where an institution has a permanent Shariah board the process for obtaining Shariah approval (which will culminate in the issuance of a *fatwa*) is generally as follows:

1. The relevant commercial department of the institution will discuss a proposed transaction or product with the institution's Shariah coordinator (or the department that co-ordinates with the institution's Shariah board).

2. The Shariah coordinator will provide feedback on the proposed transaction or product and, based on his experience, advise the relevant commercial department as to whether or not the Shariah board is likely to grant Shariah approval. In the event the Shariah coordinator feels that the transaction or product will not receive Shariah approval, he will suggest changes that should be made to improve its chances of receiving Shariah approval.

3. Once any changes suggested by him have been made, the Shariah coordinator will submit the necessary details of that transaction or product to the Shariah board.

4. The Shariah board will consider the transaction or product and will either ask for changes to be made before approving it or they will approve it as submitted.

5. If satisfied, the Shariah board will issue a *fatwa* confirming that that transaction or product is Shariah compliant.

Where an institution does not have a permanent Shariah board it may appoint a temporary Shariah board or a single Shariah scholar (depending on the circumstances). The institution could liaise with the Shariah board or Shariah scholar directly with a view to obtaining Shariah approval for the relevant transaction or product. Alternatively, the institution may engage an independent Shariah consultant to liaise with the Shariah board or Shariah scholar with a view to obtaining

Shariah approval. The role undertaken by an independent Shariah consultant is usually similar to that undertaken by an internal Shariah coordinator. (IDLO: 2009)

SECTION 3.5 ISLAMIC FINANCE, IS IT REALLY ISLAMIC?

So far, we are able to understand what Islamic finance is about. Seems like, everybody would agree that Islamic finance is quite fair system. This fair system would be equally beneficial for all participants if it is adopted purely. But factor of "honesty" of people is crucial. A huge amount of criticisms addressed to IFIs. More correctly would be to say addressed to Shariah scholars for giving *fatwa* to not compliant to Shariah products. There are opinions, that people using Islamic financial services are unaware that they are actually cheated.

These are some fragments from BBC News (2002):

"But Agence France-Presse reports that the Islamic theological research committee of Egypt's Al-Azhar institute - seen by many as the philosophical centre of the dominant Sunni strand of the faith - has voted 21-1 to approve fixed interest rates."

"Despite the problems traditionalists have with interest, nine out of 10 banking institutions in Egypt pay a fixed rate of interest."

FOREIGN POLICY's (2009):

"To their critics, many are nothing more than rent-a-sheikhs, willing to give the spiritual nod to just about any financial product for the right price. Within their own ranks, the top sheikhs debate vigorously over which new products and transactions are permissible -- and which have been unjustly allowed."

Mahmoud El-Gamal, a professor at Rice University and author of Islamic Finance: Law, Economics, and Practice:

"There's a whole industry now -- supported by a show of religious authority provided by Islamic scholars -- with banks promoting conventional products as Islamic,".

"They're preying on the religiously insecure." And as the financial crisis continues to unwind, there are a lot of insecure people out there."

The list of citations and criticisms could be continued for several pages. These criticisms touch Islamic securities industry, Islamic insurance, deposits to Islamic Banks, etc. At the same time these criticisms touches not all IFIs. For example Al Rajhi Bank of Saudi Arabia is claimed to be most Shariah based bank and best retail Islamic bank by many people. Nevertheless, it is undoubtedly that Islamic Banks need good products to flourish.

SECTION 3.6 PLS PRODUCTS DESERVE MORE ATTENTION

Surely it is more difficult for Islamic Banks to lend money strictly based on PLS agreement. This type of financing is more risky because there are many uncontrollable factors. Most crucial factor is that it is really hard to control and check the honesty of the borrower. Because, since it the PLS agreement the borrower has incentive to under-declare profit. Therefore the project will require constant monitoring which is time consuming. Secondly, it is difficult to determine the ratio of sharing the profit and loss. It would be easier just set the fixed rate, but it is not allowed in Islam, neither in Christianity, neither in Judaism.

As mentioned earlier in Chapter 1 of this research, most of the financial products and services provided by Islamic banks to finance private business sector are targeting *natural certainty contracts* which introduces briefly in section "**3.3.5 Other modes of financing"** of this chapter. Let us find some facts to support this view. Malaysia is considered to be a centre for most innovative Islamic banks. Thanks to Central Bank of Malaysia (Bank Negara), we can easily access the official statistical report on issued loans by types or how they call it by concepts. It is obvious that Islamic banking, as it is practiced today, tends to deviate from the PLS type of financing.

On March 2009, only 1.6 percent of issued loan by IFIs are based on PLS sharing products. 0.36 and 1.23 percents for *Mudharabah* and *Musharakah* accordingly. The year later, on March 2010 the overall situation is slightly better. The proportion of *Mudharabah* loans in total issued loans decreased to 0.21 percent while *Musharakah* loans reached 2.1 percent. Thus, in total 2.31 percent of contracts are based on PLS instruments. This is too little taking into account that there are more than 10 types of financing products. Islamic bank financing in practice, is still based largely on non-PLS modes of financing.

On the liability side, however, *mudarabah* (profit-sharing) deposits, which account for 70% of total Islamic deposits, are more predominant. This result, in general, is consistent with Islamic banking experiences in other countries, such as Bangladesh, Egypt, Iran, Pakistan, Philippines, and Sudan (Mills and Presley: 1999). This means that, when IFIs receive deposits, they want depositors to share the risk with banks, while at the same time they do not want to share the risk of the borrower when they issue loans. Of course it is not prohibited to choose this kind of strategy, since the goal is to make more profit and reduce the risks. But, this ignores the spirit of the usury prohibition, and therefore is unfair strategy.

SECTION 3.7 SUMMARY

So far in the research we:

- learned the basics of Islamic finance and determined distinguishing features of IFIs:
- determined that *Musharakah* and *Mudharabah* are *natural uncertainty contracts,*
- arrived at a conclusion that *Musharakah* and *Mudharabah* are:
  - PLS based types of financing:
  - Very risky instruments:
  - Considerably unused by FIs.

From now on, the research will analyze Islamic MSE finance industry, and concentrate on determination of the factors that hinder application of the *Musharakah* and *Mudharabah* types of financing.

CHAPTER 4. IDENTIFICATION OF PROBLEMS

The model of implementation that will be developed in this research is not targeting financing the poorest people only. Although it could be considered for poverty alleviation purposes, and in fact microfinance is a tool for supporting poor people, the primary goal is to assist banks or other financial institutions in application of PLS based financing and thus support low-income people.

So far, the findings of the research brought to the inference that PLS based type of financing is insignificantly practiced today. In the previous chapter in the example of Malaysia the evidence is provided, which shows that the *Musharakah* and *Mudharabah* financing constitutes less then 3% in the total types of financing. From now on the research will concentrate on the finding the hindrance for using these risky Islamic financial products. So the main question for this chapter is: **Why for IFIs it is inconvenient to use *Musharakah* and *Mudharabah*?** Answering to this question fulfills the second objective of the research which is *"Evaluate critically MSE financing/investing products provided by IFIs and identify the very points needed in improvement"*.

To fulfill this objective, the chosen strategy for data collection and analysis was interview with the specialist of IFIs that has experience and knowledge about lending activities. The interview is probably the way of collecting of most reliable information. Because, in spite of so much opinions about the importance of PLS based financing, it is clear and evident that IFIs are trying to avoid this type of risky financing. Therefore, only through interview it is possible to determine the real problematic factors of such lending.

As it is mentioned in Chapter 1, basically *microfinance* is understood as an effective tool for poverty alleviation. Microfinance is constituted by a range of financial services for people who are traditionally considered non bankable, mainly because they lack the guarantees that can protect a FI against a loss risk. Microfinance allows people with no collateral access financial services and enables them to try escape from poverty. Very effective type of microfinance model is based on solidarity group lending in which every member of a group guaranteed the repayment of all members. This model became very famous with the experience of Grameen Bank initiated by Nobel Prize winner Dr. Mohammed Yunus.

The true revolution of microfinance is that this tool gives a chance to MSEs who were denied the access to the financial market opens new perspectives and empowers people who can finally carry out their own projects and ideas with their own resources, and escape assistance, subsidies and dependence. Microfinance experiences all around the world have now definitely proved that the MSEs demand a wide range of financial services, are willing to bear the expenses related to them and are absolutely bankable. The target group of MSE finance is not constituted by the poorest of the poor, but those who live around the border of the so called poverty line, and those who:

- have entrepreneurial ideas but lack access to formal finance
- have certain skills, abilities or knowledge (craft, trade, some types of services, etc), but need start-up capital, and
- are running certain small-size business but need more working capital to enlarge the business.

SECTION 4.1 MAIN PROBLEMS IN FINANCING MSEs

Micro and small enterprises are identified as those having fixed capital or the number of workers under certain threshold levels. Microenterprises constitute small businesses and shops, cottage industries, transport services, etc. Three broad categories of economic activities can be identified namely, production, trading, and providing transport services. In production, the poor may be involved in agricultural or non-agricultural activities. Agricultural activities include farming, cattle rearing, poultry rearing and fisheries. Non-agricultural production can cover a wide variety of activities ranging from food processing to producing different handicrafts and household items like pots, mats, cloth, etc. Trading includes shop keeping, small business, and selling specific items like vegetables, fish, etc. Providing transport services can be through rickshaws, boats, or motor vehicles used as taxis. (H Ahmed: 2002)

Both Islamic as well as conventional FIs have the same problems and difficulties in financing small business. The first reason is probably related to the issue of collateral. A majority of poor people can not afford to provide a valuable for the bank collateral. To deal with this issue so called

Village Banks were established, were banks issue loans to member of groups where each member acts as a guarantee for the issued loan to the other member of group.

Other reason is that many MSEs are “not-official”, meaning that they are not registered according to the law, do not have bank accounts, clear records of past operations, financial statements, etc. It is not advantageous for small businessman to be registered officially since it is not just time consuming activity but also money consuming. The registration of a business is not the case, but the problem related to all the documentation processes which must continue along with business activity. The poor people as a rule are not well educated to be able to deal with this continuous time-consuming process. Also registration is disadvantageous because it will make people to pay official taxes and other payments. For poor man it is unthinkable to pay taxes.

The issue of unofficial business activity brings to another problem. Since there are no official financial statements of the venture it is quite difficult to assess the creditworthiness of the business. Also, most of the small-scale entrepreneurs do not distinguish the capital and assets of the business from the family properties. The business is within the family. Everything which belongs to the family (money, fixed assets, human capital) is used for the business. But today, this problem is not a big issue. Nowadays, very good and effective methods of analysis were developed by conventional MFIs. For the credit analysis, this implies that MFI have to collect and cross-check relevant primary data, in particular by visiting the borrowers’ business and households. The economic situation of the applicants' households and other related parties has to be included in the credit analysis.

Another problem is related to the economies of scale of the microfinance operations by the MFIs. As the size of the loan for microenterprise is small, the administering cost of loans increases dramatically. Each loan/application is individual issue which requires a certain amount of time to deal with. A big number of issued loans to small business do not mean that cost per loan decreases. These economic factors make it impossible for traditional FIs to offer credit to MSEs on small interest rates.

SECTION 4.2 MORE PROBLEMS FOR ISLAMIC FINANCIAL INSTITUTIONS

In addition to aforementioned issues IFIs have many more difficulties. In earlier parts of the research, the evidence was provided to prove that PLS based financing products namely *Musharakah* and *Mudharabah* almost not practiced by Islamic Banks. The research published by Islamic Research and Training Institute (IRTI) a member of the Islamic Development Bank group proves that this issue concerns not only banks but microfinance institutions as well.

IRTI (2008) noted that Islamic microfinance in spite of the richness of literature remains highly *Murabahah*-centric (not PLS based instrument). PLS, though highly acclaimed as "ideal" is hardly used. Agency problems with PLS in mainstream Islamic finance have already been highlighted as a matter of grave concern that pushes Islamic FIs to opt for debt-based products. Other problems that are usually cited with PLS based modes as compared to sale and lease based modes are as follows: One, PLS mechanisms require long-term involvement by the microfinance institutions in the form of technical/business assistance which raises the cost of implementation. Two, the uncertainty about profits is a major drawback of the PLS models. Although microfinance programs have information on local market behavior, weekly profits fluctuate. Fluctuating profits make it extremely difficult for institutions to predict their cash flows. Micro-entrepreneurs make the job doubly difficult by not keeping accurate accounts. Three, the PLS model is difficult to understand for loan officers and borrowers alike. Even in the hypothetical situation that profits were known, the borrower has to repay a different amount each period and the loan officer has to collect a different amount each period. This lack of simplicity, relative to equal repayment installments, is a source of confusion for borrowers and loan officers.

My personal view regarding hindering factors of PLS types of financing were related to difficulty of establishing honest relationship with the borrower and uncomfortable way of charging interests. My views are justified according to IRTI's report. According to IRTI study (2008) there are several possible reasons for the poor adoption of the PLS paradigm in practice. First, unlike conventional banking, PLS financing encounters severe principal–agent problems. Moral hazard problems associated with ex-post information asymmetry, for example, are especially significant in PLS financing because the entrepreneur (borrower) has incentive to under-declare or artificially reduce reported profit (Mills and Presley, 1999). Also, in the case of *Mudarabah*, the entrepreneur has an incentive to undertake high-risk projects because the entrepreneur is actually given a call option whereby he or she gains on the upside but bears no losses at all on the downside. PLS financing, thus, requires more costly monitoring. Second, the adoption of PLS financing is disadvantaged by a lack of management and control rights (Dar and Presley, 2000). In *Mudarabah* financing, for example, the bank provides all the risk capital, but the management and control of the project is mostly in the hands of the entrepreneur. The lack of management and control, in particular, accentuates the principal–agent problems associated with PLS financing.

In order to understand more about hamper factors of application of *Musharakah* and *Mudharabah* in MSE financing or microfinance, the interview with specialist of Islamic bank was accomplished.

SECTION 4.3 PRACTICAL APPLICATION OF MUSHARAKAH AND MUDHARABAH

4.3.1 Initial aim of the interview

In the beginning, the main aim of the research was slightly different. I already knew that PLS based financial products are poorly applied by banks, and therefore the aim was to create better financial products. With this initial intention aim the objective was to study the jurisprudence of Islamic finance. By doing so, I thought I would be able to develop financial products based on PLS principles, namely based on *Musharakah* and M*udharabah* principles. But surprisingly, conclusion I made after qualitative research changed the initial aim of the research. It became necessary to change aim from “creating the product” to “searching of the implementation method of the product”.

Why? Because I understood that it is not possible to change the terms of *Musharakah* and M*udharabah* considerably, otherwise it will not be PLS based anymore. Since main principle of these contracts is about sharing profit and loss fairly for both borrower and financier, it must stay within this principle. All the conditions of *Musharakah* and *Mudharabah* loans, starting from extending the loan ending with finishing the contract are already determined and approved by Islamic scholars. According to the interviewee, the approved terms and conditions of *Musharakah* and *Mudharabah* contracts are the same or almost the same in all countries and all FIs. Sometimes there may be insignificant different views of scholars regarding some specific episodes in operation, but mainly the terms and conditions are the same.

After such discovery, it became necessary to analyze some cases of *Musharakah* and *Mudharab*. Two cases from the practice are outlined in next 2 sections. Also, after findings of first interview, it became necessary to make another round of interview with totally different questions.

4.3.2 Musharakah case

Section 3.3.2 of Chapter 3 describes the theory of *Musharakah*. Literally the word means sharing while in business it means a joint enterprise in which all the partners share the profit or loss of the joint venture. (Usmani: NA) Now, let us give small practical example of *Musharakah* operation.

Suppose that a man running a small business. For example: a tailor became the best in his area. Because of the good quality of his ready-made garments the number of his customers has doubled. In order to make more profit, he decided to concentrate on serving relatively richer people. But to do so tailor will need more money to purchase better quality of fabrics, threads, and other expensive semi-products. It means he needs money for working capital. The bank decided to invest to his small business on terms of *Musharakah.* The total business value of tailor was 60 units. Bank financed another 40 units. Now total value of business is 100 units. They agreed that they will share profit at 70% for tailor and 30% for bank. It is acceptable that profit sharing ratio may be different from the invested ratio, but minority scholars believe that profit sharing ratio must reflect investment ratio. I support those who think it may be different. What about the loss? In *Musharakah* terms, all agree that loss is shared according to the ratio of investment (Usmani: NA) Now we have following picture.

Value of business	= 100 units
Profit sharing ratio	= bank 70% and tailor 30%
Loss sharing ratio	= bank 60% and tailor 40%
Ownership ratio	= bank 60% and tailor 40%
Contract period	= assume 6 months

Parties are free to choose *permanent Musharakah* where the profit and loss are shared on agreed ratios upon cancelation, termination or finishing the contract. Or they may choose *diminishing Musharakah* where tailor repays bank's profit and principal at agreed schedule and after each repayment the investment ratio of the bank decreases according to the repaid amount.

Now, let us assume that *permanent Musharakah* was chosen. Till the end of the 6^{th} month the value of the business increased till 200 units. Does this mean that bank entitled to receive 80 units because of 40% ownership in the business? No. Because in *Musharakah* any increase in the value of business is shared at agreed profit sharing ratio. So, the value in the beginning was 100 units and it increase with another 100 units. Hence, at the end of 6^{th} month bank will receive 70 units. It comes from 40 units (40% of initial value) plus 30 units (30% of increased value). In case of loss, however, any decrease in the total value of the assets should be divided between them exactly in the ratio of their investment. It means, that if at the end of 6^{th} month the value of the business is 90 units, then the loss of 10 units will be shared at agreed ratio. Hence, tailor receives 54 units (not 60) and bank receives 36 units (not 40).

Musharakah may be used for almost any types of projects regardless the size of the business and length of the project. Of course the larger the project the more complicated is agreement, since many things should be determined and agreed. Also *Musharakah* may be used in participation in single operations. The abovementioned case is very simple but still creates clear picture.

4.3.3 Mudharabah case

In both *Mudharabah* and *Musharakah* contracts financier and entrepreneur are partners. But in *Mudharabah* the financier invests only money and the entrepreneur invests labor. Entrepreneur is rewarded for invested labor and financier for invested money. Just like in *Musharakah* the profit-sharing rate is predetermined, but the amount of profit is unknown. The loss is totally born by financier only, but if business faces loss due to the fault of the entrepreneur than he will cover the loss with his entitled share for profit. Entrepreneur has chance to increase his shares little by little and eventually privatize the business. With each repayment of entrepreneur, the financier's share becomes less and the profit also decreases accordingly. Now let us consider another case with *Mudharabah* application.

Assume that the same tailor has 20 year old son. He is also tailor, and already good enough to start his own business. Son has skills, potential customers but not money. He proposed the bank to invest money to his business under *Mudharabah* contract. They came to decision that the value of the project is 100 units while business may make 40 units of net profit per month. They agreed that profit sharing ration is 50% for each. The invested money should be repaid at 10 units each month. Now we have following picture:

Value of business	= 100 units
Net profit per month	= 40 units (assume it will not change)
Profit sharing ratio	= tailor 50% and bank 50%
Loss sharing ratio	= tailor 0% and bank 100% (if it is not caused by tailor’s fault)
Ownership ratio	= tailor 0% and F 100% (will change with repayment accordingly)
Contract period	= assume 10 months

Let us assume that in this case, parties agreed on *diminishing* type of *Mudharabah.* We know that in the beginning 100% of the business belongs to bank. After first month tailor will pay to the bank 20 units as profit sharing which is 50% of the net profit. Also B will payback 10 units to bank to repay debt. Thus, bank receives 30 units and tailor keeps 10. As a result for the next month the ownership ratio will become 10% for tailor and 90% for bank. It means next time 90% of profit will be shared among them at 50 to 50 ratio. Tailor does not have to share the profit made on his own share. Consequently, profit of bank will be 180 units plus repayment of capital 100 units, in total 280 units for second month. This will continue till the 10^{th} month when share of bank will be 0%. Eventually tailor will become the owner of the business.

This loan product has several drawbacks. The most important is the uncertainty of the profit. In this case we assumed that business makes same profit each month. Unfortunately in practice it is impossible.

4.3.4 Interview as a Qualitative research 1

In earlier sections of this chapter (**4.1** and **4.2**) the research described factors that make financing MSEs risky. We determined that in addition to conventional problematic factors, Islamic MFI face more problems. In order to learn how MFI deal with these problems today, the interview with two specialists of Islamic bank was accomplished. One of them works for more than 5 years in accounting department of Islamic Bank. The other interviewee used to work in both MFI and commercial bank. Currently he is head of marketing department of the Islamic bank. Moreover, he used to take main part in development of SOP (standard operation procedures) for microfinance scheme. Both of them possess good knowledge and experience in Islamic Finance. Because of reluctance of the interviewees their name and the name of the bank they worked for will not be disclosed. For convenience, let us name them Mr. X.

According to Mr. X, one of the main problems is that SMEs do not record their business transactions. Actually this problem exists not only for Islamic MFIs but for any MFI. He says that a lot depends on loan officer who can assess the condition of the business. It is time consuming process which increases administration costs of MFI.

Another big problem of PLS based financing is related to monitoring of the entrepreneur. Almost everyday officer visits borrowers business in order to check the existence and income of the business. Not only under declaring of profit by borrower is the risk, but Mr. X says that borrower may just disappear. Because of the small size of the business, it is not a difficult task to sell it and run away with money. Thus, huge amount of time spent for monitoring makes the financing costly.

It is not already secret for us that, because the profit and loss may not be determined in advance, it creates problem. According to Mr. X it is still not totally solved issue. Most MFIs do not share the net profit but they determine approximate ratio of net profit to total income. With this ratio MFI needs only to know total income of the business at needed period. Mr. X was agree with me that determination of the net profit in this way will not give the real exact number. Moreover, if the financier is bank, it will require from borrower to operate through bank account in order to keep track on income, which is not comfortable for some borrowers. My proposal to this issue was to create very simple manual for the borrowers which will show how to calculate net profit of the business. Then teach them how to use the manual. Mr. X agreed with my idea and told that actually some experts already working on this idea.

My experience proved that MFI needs to establish good marketing strategy in order to find good potential borrowers. With my conception that their MFI did not have good marketing strategy I asked Mr. X about it. I was wrong to think so. According to him, officer of the bank always analyze the market in order to find reliable and profitable businessmen and propose them their services.

Also I know that to maintain loan portfolio in good condition, it is very important to create incentive to officers. Mr. X explained that in their country, in microfinance industry officers receive very competitive salary, and it is quite prestigious to work in MFI or microfinance department of commercial banks. In addition to the salary, they receive bonuses if they are able to meet target plan. Mr. X agreed with me that this system of paying bonuses does not create strong incentive. My proposal was to introduce another bonus system where the amount of the bonus will depend on the profit received from the loan portfolio of each officer. At the same time if officer has overdue loan in his portfolio it will affect the bonus. Hence, they will always try to find good partners and monitor own portfolio. This practice is used by best MFI nowadays and already proved efficiency. Mr. X agreed with me that this bonus system creates better incentive then the one practiced in his MFI.

In general, Mr. X was agree on my proposal and idea about the strategy of successful implementation of *Musharakah* and *Mudharabah*, which will be described in later part of the research. In addition to my idea he proposed me to think over of how to change the mindset of the borrowers. Because establishing reliable relationship among partners is of crucial importance in business especially in undertaking *Musharakah* and *Mudharabah* contracts.

SECTION 4.4 SEARCHING POTENTIAL FEATURES OF CONVENTIONAL FINANCE

My own work experience was mainly related to financing small and medium size enterprises (SME). I worked in one of the largest local banks of Uzbekistan. In 2001 our bank started piloting EBRD's (European Bank for Reconstruction and Development) SME financing project which was named J-USBP (Japan-Uzbekistan Small Business Program). Under this program EBRD assigned external consultants (a German consulting company) to implement lending to SMEs and supervise the program. The model proved to be excellent and my intention was to borrow some episodes of that model for the research. But, in order to prove to myself about considering this model as best opportunity, I accomplished interview with a professional in Microfinance industry who has deep knowledge and experience in SME financing projects and familiar with this industry on international level. He is currently undertaking MBA course in International Islamic University of Malaysia and also tries to contribute for development of Islamic Microfinance. It was of vital importance for me to discuss my ideas with other independent party and receive independent feedback.

4.4.1 Interview as a Qualitative research 2

The interviewee is Mr. Muhammadjon started working as loan officer in J-USBP and due to his perfect results was invited by external consultants to become a supervisor of the project. He was promoted to level of district consultant and worked in 3 districts of Uzbekistan. In largest district he supervised 4 departments with about 15 loan officers. After completion of project he was promoted as manager to one of branches of Microfinance bank of Azerbaijan. After 3 years, suspended working in order to accomplish MBA course in International Islamic University Malaysia where currently studying. He possess up-to-date knowledge in microfinance since the company he works for is one of the best consulting companies specialized in MSME finance and he is familiar with other consulting companies (rivals) operating in the same area.

The main goal of the interview was to hear his opinion regarding possibility of implementation of MSE analysis method used in J-USBP. Also, to find out weather he would recommend something else other than J-USBP model.

Generally he agreed with the problems of Islamic MSE finance defined in this research so far. He supported my idea of application of business analysis method used in J-USBP and explained that this model is used by many more internationally recognized consulting companies. This model is applied around the world in about 100 countries and more than 300 FIs including banks, MFIs and credit unions. Many more MFIs are inviting these consultants asking guidance in establishing of smooth and profitable model to finance MSMEs.

In addition to the problems noticed by me he added the importance of creation of incentive for borrowers in order to establish good business relationship with them. According to his views this issue is not a big problem for conventional banks but it may be a key factor for IFIs. Also he agreed with me that strategy for monitoring the borrowers in IFIs is quite weak since it requires too much time and still not productive.

Mr. Muhammadjon and Mr. X (two interviewees from Islamic Bank) showed admiration regarding the model of implementation of PLS based products that I was going to develop in this research. The mutual conclusion was that although some part of my idea is already under consideration by others (marketing strategy, strategy of education of borrowers), it still has some episodes that nobody thought about.

SECTION 4.5 SUMMARY

As a result of literature review and qualitative research, in implementation of PLS based products following problems were determined.

1) Many entrepreneurs are not able to provide sufficient collateral to secure the debt.
2) It is not easy to assess financial statement of entrepreneurs because most of them do not keep the books.
3) It is difficult to determine the ratios for sharing profits and losses.
4) Entrepreneurs received financing from the bank may have inclination to under declare profit in order to pay less than required.
5) Because of uncertainty concerning future profits of the businesses it becomes necessary constantly perform monitoring and even revisions to the business. It means monitoring of the projects increases administration expenses.
6) Because of huge amount of time spent to monitor the projects, officers will not have enough time to conduct marketing in order to find more potential partners.
7) Even in the hypothetical situation that profits are known, the borrower has to repay a different amount each period and the loan officer has to collect a different amount

each period. This lack of simplicity, relative to equal repayment installments, is a source of confusion for borrowers and loan officers.

8) Stimulation of both bank workers and entrepreneurs also needs attention.

Next chapter of the research will propose solutions for abovementioned issues. The feature of the next chapter will be in the form of a manual which proposes a model for implementation of *Musharakah* and *Mudharabah* financing. In proposing solutions for questions 1, 2 and 8 I used techniques resembling those in J-USBP model. The overall structure of the model and solutions for all the rest questions are based on my own ideas and comments of interviewees. I discussed my ideas beforehand with all three interviewees and received positive opinion on them.

CHAPTER 5. MANUAL

SECTION 5.1   GENERAL

The title of the manual is:

"Strategy for piloting the MSEs financing on the basis of *Musharakah* and *Mudharabah.*

5.1.1 Purpose of the manual

The purpose of the manual is to use it as strategic model for developing investment business with micro and small enterprises (MSE) by implementing Islamic financial products based on profit and loss sharing (PLS), namely based on *Musharakah* and *Mudharabah*.

The model proposed in this manual helps in procedures for setting up of entire investment cycle. Principally, within the basic structure, the model could be refined and changed according to specific local needs like legal requirements, banking regulation, internal policies and other particular requirements.

5.1.2 Main aim of the model

The main aim of the model is to provide financial support to MSEs through *Musharakah* and *Mudharabah* financings.

5.1.3 Users of the Manual

The model in this manual is proposed for utilization for any FI dealing with providing Islamic financial services, including non-for-profit institutions. Particularly, the model is recommended to those microfinance institutions (MFI) which in addition to profit making goals has a mission for the social support of the population by establishing new working places.

5.1.4 Basic principles of the model

1. FI should not wait for partners to come and ask for the financing of the project, but on the contrary, should act as an institution that actively searching for investment opportunities.

2. FI has to provide project officer (PO) with freedom in choosing partners for investment and independence in decision making. PO is fully responsible for all projects in his portfolio until the full termination of the project.

3. FI should guarantee the non-disclosure of information related to the business and personal issues of the entrepreneur. This is main factor in establishing long-term trust relationship between the FI and partner.

4. FI should apply graduation principle in respect of entrepreneurs who proved to be reliable partner. The factor of honesty has to be of supreme factor in assessment of the reliability of the partner.

5. All the procedures within entire investment cycle should be done in a transparent and accountable manner for both financier and partner.

6. Collateral provided by the partners is not considered as a main guarantee for repayment of the funds but as a secondary reserve tool for pushing dishonest partners. The main factor for the guarantee of repayment of the funds should be the reputation of the partner.

7. Each investment operation must be agreed and approved by credit committee in a democratic and transparent manner.

8. Rewarding system for PO is integral part of the model and must be secured by FI.

9. PO has to memorize the definition, terms and conditions of both *Musharakah* and *Mudharaba* concepts determined by the FI.

10. FI is responsible to secure and assist fulfilment of each principles listed above.

5.1.5 Overall structure, goal and mission

The model assumes a pilot phase which consists of two pilot periods. **Musharakah period, Musharakah and Mudharabah period**. Second period will be based on findings of previous period. The investment will start only with *Musharakah* and in the second period of both *Musharakah* and *Mudharabah* will be applied. The length of both period depends on how successful was first period. But, model proposes 1 year including four months for the first period and 8 months for the second. The model has a goal and mission.

Goal. Determine potential partners and expand investment portfolio.

Mission. Constantly observe and analyse the situation in the market and collect information. The collected information should help to:

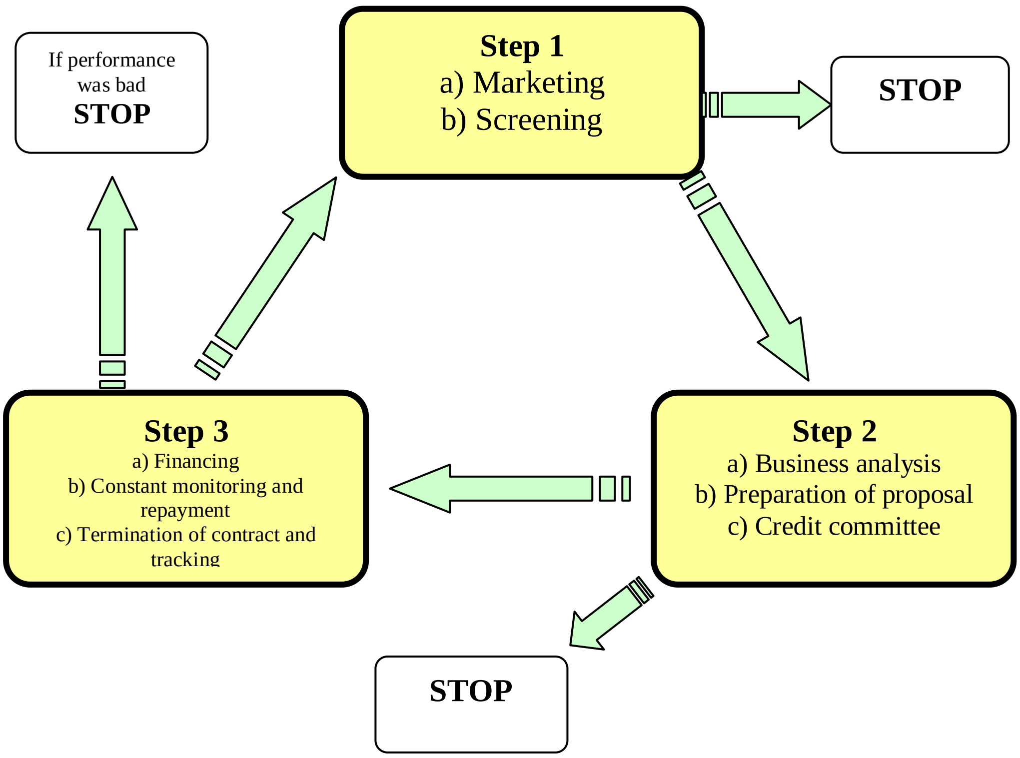
a) Find out the types of businesses that promise to be relatively more profitable and stable.

b) Determine people who could possibly become potential partners for *Mudharabah projects* in the next periods.

c) Be aware of possible changes in the economy or market that may negatively and positively affect investment portfolio.

5.1.6 Investment cycle

According to second principle of present model, PO is responsible for own portfolio. It means that PO has to control *investment cycle* of each project starting with finding the partner and ending with termination of the project. *Investment cycle* of each project has 3 important steps. If all requirements of each step are fulfilled PO officer proceed to next step.



SECTION 5.2 PERIOD 1 - MUSHARAKAH PERIOD

The *Musharakah* period is the most important, most time consuming period and most costly period. In order to obtain best knowledge about the market, as many as possible projects should be financed at this period. At this period, it is strongly recommended not to invest in long-term projects. The success of the second period very much depends on success of the first. The better the performance at this period, the faster and better second period starts. The length of Musharakah period is four months.

5.2.1 Target MSEs or potential partners

The target MSEs in Musharakah financing are those who already established their business and able to utilize additional funds for development and expansion. They are called potential partners. Because when if investment is issued, the entrepreneur will not become a *borrower* like in conventional banks, but *partner*. The funds could be spent for any halal purpose which somehow benefits the business. For example:

- any kind of working capital for increasing business capacity, or
- purchase of equipment or machinery that will foster business tasks
- purchase of fixed assets or inventory
- financing account receivables

5.2.2 Step 1

Step 1 consists of Marketing and Screening. Marketing is searching the potential clients and screening (determination weather a client matches all criteria or not).

5.2.3 Marketing

Marketing is not scheduled and does not have any deadlines. Within *investment cycle,* the responsibility of each PO is to constantly conduct market survey. It starts with so called **direct marketing** which is conducted by informing entrepreneurs about the availability of financial services. Direct marketing is performed by visiting business centers, bazaars, trading centers, service or workshop places where potential partner established own business. Indirect marketing through advertising on TV or newspapers is also desirable. The ability of PO to deliver the information in appropriate way is crucial factor for success. Since PLS based financing requires exposure of the business details, PO has to be able convince entrepreneur that all information is secured.

Each PO has to develop small handbills for distribution which contains brief and understandable information about available financial services. The handbill should contain name and contact information of PO so that if entrepreneur decides to use services, he will be able to find the needed PO. It is important for POs because they need to keep potential partners for their own portfolio.

5.2.4 Screening

Screening is a process during which PO has to determine whether the entrepreneur is actually eligible to become a partner for FI. FI has to constitute eligibility criteria which corresponds to the internal polices and regulation law of the country. But, despite specific local rules of each country, following criteria is important to be matched by the potential partner:

a) The main activity has to be halal activity.

b) Business has to be controlled and owned by entrepreneur.

c) If several members of the family are involved in business, there must be one clear leader/manager.

d) The business has to be in operation for more than 6 months and owner has to possess good knowledge about the business.

e) The established business and its premises have to be within determined by FI zone.

f) The business to be financed must have a regular cash flow.

g) The entrepreneur has to be ready to disclose the information of the business.

h) The entrepreneur has to understand that PO does not guarantee the financing since the conclusion will be issued after discussion committee meeting.

Also, FI has to prepare black list of businesses that may not be financed. For example:

a) Production or trade of arms or military equipment.

b) Investment in securities.

c) Financing of existing debts.

d) Etc.

5.2.5 Step 2

If, when the entrepreneur passes screening process, PO starts step 2, which consists of business analysis, preparation of proposal and discussion committee.

5.2.6 Business analysis

Business analysis starts from visit to business place. First of all PO need to learn how the business operates. If the business is trade then the activity is very simple to understand, because the entrepreneur buys and sells. Service business is a bit more difficult since it is not so easy to calculate cost per service. The more difficult case when the business is of production. Because, PO will have to learn how production process operates. Sometimes it may include the analysis of equipments and machinery in use, the market of raw materials, relations of the entrepreneur with the suppliers, etc. There are several difficulties in obtaining needed information for the analysis.

	Difficulties	Actions of PO
1	Usually, most of the MSEs do not have documents and clear records.	PO is responsible for obtaining all the needed information by asking about sales, expenses, cash reserves, movable and fixed assets used for business, etc.
2	Usually MSEs do not trust. PO should not expect that entrepreneur will provide all information easily.	PO is responsible to ask for all details, and have to be able to convince that the information is necessary and will be save.
3	Entrepreneur may try to under declare real profits. Or they may do so fearing that information may reach tax inspection.	PO has to be able clearly explain that under declaring of profits will decrease the investment capacity and thus the entrepreneur will not be able receive needed amount. The more real and full the information entrepreneur gives, the better his chances to receive funds. Also PO has to explain that bank have no right to pass information to 3rd parties.
4	Entrepreneur may try to over declare the real profits in order to increase the investment capacity.	PO has to explain that by doing so, he may not be able to repay and thus his reputation will become bad and possibility to receive second finance will decrease dramatically.
5	Entrepreneur may not understand the questions.	PO has to be able to reformulate them for better understanding.
6	The numbers provided by entrepreneur may seem unreliable and not match each other. Usually it happens when entrepreneur tries to cheat or does not possess enough knowledge on the business.	PO has to be always careful and cross check the data.

During the business visit it is very important to try to talk with stand neighbors of the entrepreneur or workers in the business about his reputation. Also it is important to obtain contacts to suppliers or clients and ask them also.

5.2.7 Financial analysis

Musharakah financing requires determination of the rates at which profit and loss will be shared. To accomplish this task PO need to compile balance sheet (BS) and cash flow (CF) of the current business. The proposed method of analysis is described in section **5.4.**

The BS is needed for determining of PLS rates while CF will show us the investment capacity of the project. When BS is ready and CF is known, we may determine PLS ratios.

5.2.8 Determination of PLS ratio

See **5.4.3.** .

5.2.9 Determination of investment capacity and investment period

PO has to determine the investment capacity of the business. Section **5.4.4** explains proposed method of determination of both investment capacity and investment period.

In Musharakah period it is recommended to start with short-term projects. Also when preparing repayment schedule, it is recommended to schedule more frequent repayment dates within shorter periods. For example every 2 weeks. Why? For better monitoring purpose. Since it is first contract, PO may not be sure about partner. (better explained in later section for monitoring)

5.2.10 Household visit

Household visit is part of business analysis and is a source for valuable information. CF of the business should not include household expenses, however has to create basic picture of family expenditures, because the lifestyle of the family or some other family issues may become a risk for FI in the future. For example in the family, there may be:

a) Planed some kind of big ceremony that will decrease capital of the business. For example it may be wedding.

b) An ill person who possibly will need expensive treatment.

c) Some of the children will need money to study in university.

d) Something in the hose is out of fix and needed money for remount.

e) Other issues

Moreover, during visit it is a good chance to check weather living standard of the family corresponds to the data obtained from the business analysis. If according to cash flow entrepreneurs' earning is very high, but the condition in the family is quite poor, there must be something wrong, and it must be checked and the reason has to be found. A sign for apprehension could be that family does not possess major items like TV and furniture.

Or, opposite may happen. A family with little money may possess luxury items like expensive car or several kinds of expensive electronics. PO has to be suspicion about it and learn the reason. Maybe they are hiding another business. If the business is legal then it is fine, but if not, then the entrepreneur may not become a partner for FI since illegal business is a risk for whole family.

Another significant thing for PO to be checked. Usually, home is place where people MSEs save their money of the business. PO has to ask to show the money in order to include it to the balance sheet as cash.

The mission b) Determine people who could possibly become potential partners for *Mudharabah projects* in the next periods." During household visit PO should try to search for potential partners for both *Musharakah* and *Mudharrarabah* contracts. How it is done? For example in the family there is somebody who is doing some other business separately. Or maybe somebody in the family is very talented craftsman. Everybody who is able to do perform any kind of profitable activity is a potential partner for FI.

5.2.11 Security and collateral assessment

One of the main problems is shortage of collateral. However, collateral should never be considered as main factor for security of repayment. Followings are **3 primary factors** of security that PO has to carefully analyze:

Ability to repay. This factor is related to investment capacity (section **5.2.9**) of the project. In another words how much actually entrepreneur can repay per certain period.

Willingness to repay. This factor is related to the reputation of the entrepreneur. Even though all the numbers prove the success of the analyzed business, the repayment might be under the risk if entrepreneur does not feel responsibility. The good way to check reputation is through talking with neighbors and business partners of entrepreneur. Ask them about his attitude to business and how well or bad he pays his bills.

Risks. Any business has risks. Internal and external. Manageable and unmanageable. Internal risks are usually manageable. It may be: business management, honesty of workers in the business, warehouse maintenance, equipment maintenance, family issues, behavior, etc. External risks may be manageable and unmanageable. Manageable risks are: demand market, supply market, competition, etc. Unmanageable risks may be: political and legal environment, natural disasters, big economic changes, etc.

Nevertheless, even though the collateral is not the primary security factor, it is still important. During business visit and household visit PO has to find as many as possible items that could be taken for collateral. At this period (Musharakah period) it is not recommended to accept guarantees of third parties and mostly deal with those entrepreneurs who are able to provide valuable items. It is very good if entrepreneur has a car or similar valuable and liquid item. But even he has car the best way is to take mixed collateral. Mixed collateral means to take some valuable item plus several kinds of things for collateral. For example car or gold, plus other additional items like TV, carpet, furniture, and better if something which has spiritual value for the family. Even though the value of car is enough, mixed collateral is highly recommended. Why? It is almost not possible to take the old furniture and sell it to cover the debt. Yes, it is true. But even though MSEs are usually poor people they have their respect in the neighborhood and want to save their reputation. It is very good tool to use as lever against not responsible people. How? The collateral from household will stay within the family. But they will know that it is pledged and someday PO may come and say: Give me your TV and carpet to cover your debt that occurred because of your fault. Even though the entrepreneur used some cheating with FI and it was discovered by PO, they will not want neighborhood to know about it. Because it is shame when people around him see how somebody takes his furniture to cover the debt. So, additional small items for collateral are just a tool for moral inducement. All the items for collateral have to be agreed by spouse for pledging it, and the act should be witnessed by one more party (for example neighbor) to confirm the ownership of the items.

It is highly recommended for FI to establish a list of types of collaterals that shows the level of preference for FI. The collateral assessment is fulfilled according to local regulation and legislation.

5.2.12 Preparation of proposal and discussion committee

What is *discussion committee* (DC)? In conventional FIs it would be called *credit committee*, but since *Musharakah* and *Mudharabah* are not credit products, the model uses term *discussion committee*. DC is central body in the investment process. The members of DC have authority to approve, reject or suspend investment proposals presented by project analysts. Nobody should hold authority for unanimous decision in DC.

PO prepares proposal that will be discussed in DC. Even though if PO thinks that project is not profitable, PO has to prepare the proposal for not financing and explain all the details to DC members. PO has to explain everything about the business itself, owner of the business, his family and reputation. Also PO has to provide following information to members of DC:

a) Financial analysis report which consists of BS, CF, determined coefficients, and determined risks of business.
b) Information about collateral
c) Proposal of PO regarding financing or not financing the project. If proposal is negative then reason should be explained.
d) The proposed PLS ratio and explanation why these ratios are appropriate
e) The proposed repayment schedule which shows exact dates and approximate profit from the project. The schedule has to be agreed with entrepreneur beforehand but warned that it may change after final decision of DC.
f) Determine the *secret number* and explain why the amount is adequate. *Secret number* is explained in section **5.5.**
g) Other information according to specific internal rules of the FI.

If the project is approved officially by majority of the committee members, then PO prepares and formalizes all the documents. Then the project may be financed.

5.2.13 Step 3

If the project passes Step 2, the PO will starts Step 3 which consists of financing, monitoring, termination of the contract and tracking results. From this point the entrepreneur receives status of *Musharakah partner*.

5.2.14 Financing

After formalization of all related documents and legalization of all needed contracts PO arranges all technical procedures and finances the project. From now on the monitoring will start which is most important but difficult part.

5.2.15 Constant monitoring and repayment procedure

Monitoring is of crucial importance in each period of the model. Nevertheless, in Musharakah period it is the most difficult and costly because it will require almost uninterruptedly accomplish the monitoring. Monitoring starts right after the money was provided to the partner, by checking if he spent it properly. If the money was used to buy some asset, partner should show it. If the money was used for replenishment of working capital, just oral report is sufficient. But if there are any documents proving the usage of money, it is advised to make a copy of them. PO has to be always aware about the situation in the business of partner. Is he working? Is he healthy? Is not he skipping working days because of irresponsible attitude to the business?

Partner should make repayments on determined days according to schedule which was agreed. PO has to explain that if partner wants to have constant access to the financing facilities he should prove that he is responsible person by fulfilling the terms of the contract. For a repeat financing with better conditions a partner can only qualify if he always pays back fairly and on time. With his repayments the partner builds up a personal history.

PO is responsible to explain to the partner that it is better to repay duly, because second contract will have cheaper profit share ratio, longer period and larger amount. But if not, second contract will be with the same strict terms or even there will be no second contract at all. Making softer conditions for good partners on the second contract is called ***graduation principle.*** *Graduation principle* is an instrument to induce partner not just repay but repay duly. At the same time it is incentive for them to prove that they are reliable partners.

Monitoring takes a lot of PO's time. It is definitely that the amount of profit of the business is not fixed. How do we know that the paid amount of share to FI is correct? Checking the numbers before every repayment is time consuming and not effective. But, it is important not only for FI but for PO as well, because his bonus (bonus calculation is described in section **5.6**) depends on the profitability of his portfolio. Using *secret number* (section **5.5**) as an instrument may help save precious time. The *secret number* is called secret because partner should not know about it.

How repayment should take place? In less developed countries, usually electronic transactions are not popular. On the day of repayment, partner should bring the money to be paid and *calculation report*. PO will compare the amount that partner wants to repay with a *secret number*. If the amount that partner wants to pay as FI's share corresponds to *secret number* than probably partner is honest. There is no need to spend time for inspection of the business. But if the amount that partner wants to pay as FI's share is very different from *secret number* this is alarm for PO. Partner has to explain and prove why profit is so small. If there are not enough arguments then PO has to make a visit to business and check everything himself. *Secret number* is an instrument for monitoring that helps to save time. However, it is highly recommended to do at least one revision of the business even if it is seems that partner is always honest. Musharakah period is checking period. To learn how *secret number* is determined, see section **5.5**.

Why the *secret number* is important to keep in secret. Because if partner gets to knows, he may find the point till which it is save to cheat. In other words, if *secret number* is 100 and the real profit of the FI is 120, the partner may pay 105 knowing that PO will not suspect anything above 100. But, by doing so partner keeps 15 which belong to FI actually. Therefore, it is recommended to do revisions sometimes, even if there is no reason to suspect partner.

What is *calculation report?* When PO prepared CF, he already learned in what are the receipts and expenditures of the business in detail. *Calculation report* is just a sheet of paper where the names of receipts and expenditures are listed. Also it includes small guide on how to use it and how count numbers. The idea of the report is to assist entrepreneur in keeping records and help him to determine profit and losses to be shared. Every time when any transaction is made entrepreneur make records, and one day before repayment he may use it to make all calculations. C*alculation report* is also an instrument which will save time for both PO and partner. PO has to try to tech how to prepare this report. Partner should understand that it will save his time a lot, because if PO will check the business every repayment period PO will ask a lot of questions and disturb from main activity. Therefore, c*alculation report* must be very simple and have to include instructions on how to use it. However, partner is not obliged to use *calculation report*. But in this case partner has to prove that he has another good method of calculation. One of factors of *graduation principle* is ability of partners to use *calculation report.* Because partners who are clever enough to make needed calculations will help save time for PO. Saving time is beneficial for every party.

So, *secret number* and *calculation report* are the instruments for saving time. Setting shorter periods in the repayment schedule also may save time and decrease the risk of non repayment. Shorter periods means that partner will come to FI more often and thus will be under monitoring. But how it will reduce the risk of non repayment? If the partner wants to cheat, he may cheat for larger amount if he repays every 1 month. But if he repays every week than he can cheat only for 1 week and PO reacts earlier.

It is very important for PO, to promptly and strictly react to delays in payments. Everybody should know that the organization they are dealing with is a serious organization. If they understand how FI deal with not honest partners, they will inform other entrepreneurs. Thus, little by little people will learn to be responsible when dealing with FI. They will think twice, whether to cheat or not. This is very important for FI's reputation as of institution that works only with honest people. But, if FI is not strict enough and continues financing bad MSEs, the reputation of FI will be destroyed. Partner who was lucky to cheat and receive another financing will tell to others, and will teach them how to cheat. Thus, the number of cheaters will grow.

5.2.16 Termination of contract and tracking

After partner repays fully the contract comes to end. PO has to make records about the partner's performance and the business. During recording information, PO should always keep in mind 3 missions.

a) Find out the types of businesses that promise to be relatively more profitable and stable.

b) Determine people who could possibly become potential partners for *Mudharabah projects* in the next periods.

c) Be aware of possible changes in the economy or market that may negatively and positively affect investment portfolio.

Tracking the overall process of the project should help accomplish the mission. FI should determine the list of all needed questions to be answered by PO. FI should provide the POs with software for tracking information. The software is very similar to one used by conventional banks to keep and see credit history of the borrowers. Usually they call it "Loan tracking and reporting system". Basically, Islamic FI needs such software for the same purpose, but for Islamic FI it has to contain some more information which is not needed for conventional FIs.

In addition to basic conventional information which is recorded by conventional FIs, followings are important for Islamic FI to be recorded.

	Records about	What for?
1	Punctuality in repayment	Information on how punctual was partner in abidance repayment schedule. It determines the level responsibility of the partner.
2	Fraud cases (if was), and information if partner understood his mistake and learned a good lesson	To keep knowledge about level of honesty of each partner.
3	Expected profit against real profit (assuming there was no cheat)	1. Defines the level of professionalism of the partner. How well partner is able to manage the business and cope with unexpected problems. 2. To see how profitable is each type of business. 3. To be able to observe fluctuations by type of businesses.
5	How well partner could prepare *calculation reports*	If partner learned to calculate, it means that PO will save time. Time is money.
6	Other MSE's related to the partner	They all are potential partners for FI

First of all, the information about the performance of the partner will be useful when considering second project. PO will be able assess how the business is risky and how partner is risky. PO will realize till what extent *graduation principle* should be applied in respect of certain partner. Also, since tracking software saves information on each business, it will be possible to observe different data by type of business, type of sectors and on needed period. For example PO may figure out profitability by type of business and compare with other type of business. Or PO may compare profitability of the same type of business in different periods. Etc. With this information, when searching for potential partners, PO may concentrate on best ones.

Early repayment by partner should **not** be considered as positive behavior. PO spends a lot of time to find partner, to analyze him, to prepare documents and therefore FI has to cover those expenses.

Partner, who delayed payments and cheated a lot, will not have the chance for second financing. Such partner should be put in the **black list** so that PO always aware of such person. Every time when some new partner comes to the FI asking financing, PO always have to check black list weather he is not there.

SECTION 5.3 PERIOD 2 - MUSHARAKAH AND MUDHARABAH PERIOD

Rule #1 is always to remember goal and mission of the pilot period. Together with establishing investment portfolio within first period PO collected precious information for potential Mudharabah partners. From now on both *Musharakah* and *Mudharabah* products will be applied. The model proposes applying *diminishing Mudharabah*, however it is not a must.

5.3.1 Target partners

In second period *Musharakah* financing continues at the same pace, while *Mudharabah* contract is applied for both existing business and for starting a new business. In other words, in the first period FI participates as joint-venture partner while in the second period participates as investor to start a business.

Target MSEs for *Mudharabah* financing divided into 2 groups; primary and secondary. It is strongly advised to concentrate mostly on primary MSEs. Also it is advisable not to avoid totally secondary entrepreneurs when chance arises to conclude a contract with seemingly good partners.

Primary MSEs are those who somehow have relationship with *Musharakah partners*. But if these *Musharakah partner* thinks they are not reliable people, then, they should be analyzed more carefully, but not avoided.

Generally, **primary MSEs** for *Mudharabah* are:

a) MSEs recommended by reputable *Musharakah partner*.

b) Family members of *Musharakah partner* who are able to do business but have no money to start. For example, *Musharakah partner* whose business is clothing manufacture has son. His son is already experienced enough to do business separately and already has own clients. Son is a good potential partner for *Mudharaba* financing.

c) Business partners of *Musharakah partner* and members of their families. In this case it is advised to consult with *Musharakah partner* regarding the reputation of that man. It is naturally that *Musharakah partner* is planning long partnership with FI, hence probably will not recommend unreliable person to FI.

Secondary MSEs could be:

a) Any other person, who wants and able to do some profitable activity but needs money to start. PO has to be especially careful with this category of MSEs because PO has no information on them. Naturally, there are chances that entrepreneur is really reputable person. But, who knows?

b) MSEs doing relatively more profitable type of business. By tracking the results of each *Musharakah* contract PO may figure out the more profitable type of business. The software should provide such function which shows profit per unit per type of business. With this information, PO may start marketing while keeping in mind which business is better.

5.3.2 Step 1

The *overall cycle* of *Mudharabah project* is almost the same. However some differences are there. PO should learn the differences very good.

5.3.3 Marketing

The strategy for direct marketing in Period 2 is the same as explained in section **5.2.3.** As idea PO already should possess some information about potential partners for *Mudharabah*.

All what PO has to do is keep in mind who are the *primary* and *secondary* MSEs (see **5.3.1**) for Mudharabah, and use every opportunity to obtain precious information on them. The **information is most reliable** when it is received from **reliable partner.**

5.3.4 Screening

After finding an entrepreneur who is likely to become a partner for *Mudharabah,* PO has to make screening. It is checking whether he is old enough, skilled enough and competent enough to become a partner. Depending on local regulations, additional criteria for screening should be determined by FI. However, following criteria are very important:

a) Entrepreneur should possess knowledge about the business very well.

b) Entrepreneur should possess technical skills to operate the business.

c) If entrepreneur lives with parents and business is somehow related to the family business, the approval of parents should be received.

d) Entrepreneur should be at legal age to do the business

5.3.5 Step 2

If the entrepreneur meets the criteria set by FI, then PO may start analysis.

5.3.6 Business analysis

Firstly, PO together with entrepreneur starts making business plan. The entrepreneur has to have a clear understanding of overall structure of the business. It means he should know all the numbers related to buying and selling. How much? Where to buy? Where to sell? Etc.

Secondly PO has to make cross-check whether the numbers in business plan are correct. One way to check is to compare them against numbers of the same business in *Musharakah contract*. Another way is just to go to the market and ask for the prices of related to the business products. For example if the project is production of rolls, then PO should check how much does cost similar roll in the market and find out the prices of ingredients (sugar, flour, eggs, etc).

How PLS ratios are determined?

For *Mudharabah projects* the method explained in “Musharakah period” will not work. Because the project will start operation after investment is made. Each FI has its own method of ratio determination, however in the practice it is basically following scheme. FI determines cost of the capital, then figures out average profit rate of *direct* and *indirect* competitors, then based on these factors determines own rate which will be profitable and competitive.

The model may assume usage of such method of determining profit sharing rate for *Mudharabah* contracts. But this method is does not respond to Shariah principles.

The model proposes another method which is based on mutual agreement via bargain. To apply this method we have to calculate *FLV* which is *fair local labour value***.** Also *FVL* is starting point for bargain.

What is FLV? It is average salary of other worker who involved in the same business. *FLV* could be per hour, per day, per month, depending on type of business and convenience. Why fair? Because the entrepreneur has a chance to prove that his labour costs more and may increase his share in the profit sharing ratio. Why local? Because concentration on local area only. A person who produces rolls in Bangladesh may not claim for higher profit share because of the same worker in Germany earns more.

How FLV is determined?

Let us assume that FI considering investing funs to roll production. First off all PO has to find roll production firm in local or neighbour area. Then PO needs to find about salary received by average-level worker of that firm. It is better if PO finds more producers and compares them all. Thus, PO has determines *local labour value*. Now, let us make it *fair value*. Is this salary fair in respect to our entrepreneur? No, because an ordinary worker in the firm does not have to find consumers, do marketing, go to bazaar everyday to buy ingredients, etc. That worker has no business risk except risk of losing his job. But our entrepreneur has to take care of all issues in the business. Therefore entrepreneur has right to claim for higher share in the profit.

But, what if there is no other roll producer in the city, although it is almost impossible to be so. Depending on creativity of PO and entrepreneur, any logical way of finding *FLV* may be used. Just statistical average salary in the local area also could be used as *FLV*. *FLV* is not final value, but starting point for bargain.

Let us assume that the value of the roll production project is 1000. According to business plan, project promises to yield 200 units of profit each month. PO determined that *FLV* for this type of business is 100 units per months. Considering this information PO proposes share of 50 to 50, which is 100 units for each. Now, if entrepreneur proves that his business will be better in some way, he may increase his share. His arguments for increasing share are his experience in this business, his reputation in the market of rolls, the number of permanent buyers, potential of finding new buyers, etc. If PO finds these arguments worthy, partner's share could be increased.

Let us assume that they agreed on 150 to 50 which is 75% for entrepreneur and 25% for FI. Entrepreneur's ability to repay debt is 150 units per month. The length of the project also should be negotiated. Entrepreneur has right to repay all 150 units per months, if he proves that his personal and family expenses are supported by other members of family. Just like in the case of *Musharakah,* if for example his wife working, the evidence of her official salary should be shown to PO. Or if somebody else is doing some other business, then business should be analysed, in order to see if the profit of the business is sufficient to cover family expenses.

But it is strongly recommended for PO to be conservative and ask him to repay less than 150 units per month, because the profit of the business is not fixed and not guaranteed. When repayment schedule is already determined, it should be fulfilled accordingly. If, entrepreneur will not be able to repay 150 units each period, then PO will have problematic project in his portfolio and his bonus may decrease. At the same time Entrepreneur will loose reputation. It is advisable for both of them to be conservative.

Assume that final agreement for profit sharing ratio was 75% (entrepreneur) to 25% (FI) and repayment 100 units each month. It means PO will prepare repayment schedule for 10 months. With each repayment, the ownership share of the FI in the business will decrease and eventually will become zero.

During bargain, PO should keep in mind the lowest point till which he can decrease bank's share. It can be checked by calculating proportion of FI's profit to the invested to the business amount. For example, in above example, FI's share is 50 units which is 5% of invested 1000 units. If minimum selling price of capital of FI is lower than 5%, then project is profitable for FI.

5.3.7 Security and collateral assessment

In *Mudharabah*, even though the FI is the owner of the business, it is highly recommended to take some additional collateral as security. However, just like in *Musharakah* contract, collateral is not the main security. See section 5.2.11 for 3 primary factors of security.

5.3.8 Preparation of proposal and credit committee

After all the needed information is collected, PO prepares proposal that will be discussed in discussion committee (DC). Even though if PO thinks that project is not profitable, PO has to prepare the proposal for not financing, explain all the details to DC members and then make entries to the tracking software. PO has to explain everything about the business itself, owner of the business, his family and reputation. Also PO has to provide following information to members of DC:

a) Business plan with projected CF

b) Information about collateral

c) Proposal of PO regarding financing or not financing the project. If proposal is negative then reason should be explained.

d) The proposed PLS ratio and explanation why these ratios are appropriate

e) The proposed repayment schedule which shows exact dates and approximate profit from the project. The schedule has to be agreed with entrepreneur beforehand but warned that it may change after final decision of DC.

f) Information on procurement.

If the project is approved officially by majority of the committee members, then PO prepares and formalizes all the documents. Then the project may be financed.

5.3.9 Step 3

After DC approval, entrepreneur becomes *Mudharabah partner*.

5.3.10 Financing

Since *Mudharabah projects* is investment project, it is important that PO take part in utilization of the money. For example, if the project assumes purchase of equipment PO should go to the market with partner to buy it. If project assumes buying of something which costs the same price in all shops, then it is not a must for PO to go with partner to the market.

5.3.11 Constant monitoring and repayment procedure

Overall the monitoring strategy is the same as for *Musharakah projects* (see section 5.2.15). *Calculation report* is used to save time. *Graduation principle* is applied as a tool for making incentive to partners.

But, in *Mudharabah project* monitoring, the *secret number* is not used. Instead, there is *projected profit* which was mutually determined while preparing business plan. Weather *graduation principle* will be applied to the *Mudharabah partner* for second time will depend on how well the partner may maintain projected profitability.

If the partner repays less than expected, then PO has to make revision and find out why. If the problem occurred because of the partners fault, then FI should not share the risk. And if the fault of the partner is very serious and there is a risk that it may happen again, then partner should be warned or even canceled (if extremely serious). However, even though FI receives profit as it was projected in business plan, it is recommended to make revision at least once.

5.3.12 Termination of contract and tracking

See section **5.2.16**.

SECTION 5.4 HOW TO DO FINANCIAL ANALYSIS FOR MUSHARAKAH PROJECTS

The aim of financial analysis is to determine *value* of the business and financial *capacity* of business. *Value* means how much does business worth. To determine value PO have to make up a balance sheet (BS). BS reflects the financial situation of the business and will be used to determine PLS ratios. *Capacity* means how much could be invested into the business. PO has to make up cash flow (CF) in order to determine how much can be invested into the business so that it will be repaid.

5.4.1 Cash flow (CF)

CF consists of sales, costs of goods sold, operative expenses, additional income and taxes.

Sales	
Cost of Goods Sold (COGS)	-
Gross cash flow	=
Operational expenses	-
Taxes	-
Net Cash flow	=

Sales in production

If the business to be analyzed is production, then it is not difficult to find sales. To calculate sales, PO has to ask for the quantity of goods sold in a month and then multiply this figure by the sale price. In production, as experience shows, almost all producers keep records on sales and costs.

Sales in trade

If trader keeps clear records, PO has to sum up the daily sales of the last week. By dividing the sum by seven and multiplying it by 30 we have average monthly amount. PO has to check records of last week against other weeks to see if there is no big difference. Maybe the last week was special week with large sales, or vice versa.

If entrepreneur has no records then PO has to ask the approximate sales for each day of the week assuming if it was lucky day or unlucky day. For example the business has approximately following sales during the week:

Table-1

	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday
Lucky day	900	800	1000	700	Day off	800	900
Unlucky day	700	700	900	600	Day off	600	750

First add up all numbers and divide by 14 to get statistical daily average. 9350 / 14 = 667

Second multiply daily average by 30 to get monthly average. 667 * 30 = 20010

At the end of working day PO has to check cashbox of the trader to see the sale of a day. If for example it was Monday, and in cashbox was 750, then the result is satisfying. If PO is still not satisfied with the provided reason, then PO may check cash on the next day. PO has to write the amount in the cashbox somewhere, because it will be included in the BS later on.

COGS in production

Depending on type of business the calculation of COGS may be different. PO should not just ask the COGS and write it down, but calculate everything himself. First PO has to learn the basic production structure. Then find out cost of produced items. In production, COGS is linked to materials used in the production process. All other things not physically visible in the readymade product will be accounted for as operative expenses. Those might be salaries, electricity, spare needles, oil for the sewing machines, etc. Depending on type of production, PO may use different methods of determination of COGS. For example define COGS per 1 produced item, then multiply it by quantity produced in one month. Or maybe COGS of produced 20 items at once.

COGS in Trade

PO has to obtain the information from different angles and then make cross-check. PO has to make at least one cross-check for both Sales and COGS. This is done in order to check weather trader is mistaken or cheating.

Practical analysis method and Cross-check-1

PO has to ask how much does each item costs and at what price is sold. Then ask how much of each item sold during the month. Or, during a week if it helps trader to be more correct. Then multiplying quantity of items by cost, we will get monthly COGS.

But there are some difficulties. One problem is that some traders have too many types of items in the shop. Trader cannot answer about the cost, price and quantity of each item if there are so many things in his shop. Therefore PO concentrates on best selling items. Experience shows that in many cases, only 20 – 25 percent of items represent 70 – 80 percent of total sales. Even though some items are not so remunerative, traders keep them in the shop. It is good strategy to attract buyers.

Let us assume that the shop is food-shop. PO starts with mostly sold items/goods in the shop.

Table-2

Item	Quantity per month	Purchase Price/Piece	Costs of goods sold	Selling price	Turnover
Potato	500kg	6.4	3 200	8	4 000
Carrot	400kg	6	2 400	7.5	3 000
Pepper	300kg	5.4	1 620	6.7	2 010
Onion	300kg	5.3	1 590	6.6	2 980
Oil	200lt	16	3 200	19	3 800
			12 010		15 790

There are many more goods in the shop, but according to the trader these constitute about 75 – 80 percent of total sales. Let us assume 78 percent. By defining 100 percent, we have following picture:

Table-3

Item	Quantity Sold	Purchase Price/Piece	Costs of goods sold	Sales Price	Sales
Potato	500kg	6.4	3 200	8	4 000
Carrot	400kg	6	2 400	7.5	3 000
Pepper	300kg	5.4	1 620	6.7	2 010
Onion	300kg	5.3	1 590	6.6	2 980
Oil	200lt	16	3 200	19	3 800
			12 010		15 790
Total			15 397		20 243

Here PO has determined COGS and there is chance to make **cross check-1** for sales. In section *Table-1* we can see that a sale by lucky day & unlucky day method was 20010. Comparing it with sales in Table-3 we can see that the numbers are not so far from each other, 20010 and 20243. It means that trader was correct. If not, than PO has to check everything again. Maybe trader is trying to cheat or doing mistakes.

Supply market analysis method and Cross-check-2 and 3

To start with this method, PO has to make small preparation. PO has to calculate **average gross margin** by following formula: **(Sales – COGS) / COGS**

In our case it is: (20243 – 15397) / 15397 = **0.3147** or **31.47%**

Now PO has to ask what are the main suppliers are. For example from market **A** trader brings all the vegetables. From market **B** different kind of oils and flour. From market **C** all the rest small items (matches, detergent, candle, soap, etc)

The question to be answered by trader is: How many times per month he goes to each market and how much money he spends each time. Assume that trader goes to market **A** 5 times and each time spends around 1900 and 2100. To market **B** 3 times a month and spends around 1000 and 1100. To market **C** once a months and spends around 1800 and 1900. PO takes average for each market and multiplies it by times. Market **A** (2000 * 5) = 10000, **B** (1050 * 3) = 3150, **C** 1850. We have 10000 + 3150 + 1850 = 15000. The monthly purchase in the amount of 15000 is nothing more than just COGS. Now PO may do 2 more cross-checks.

Cross-check-2. In *Table-3* COGS is 15397 which is close to 15000. It means the obtained information is about correct.

Cross-check-3. Till now we have two numbers for sale, which is 20010 from *Table-1* and 20243 from Table-3. If we multiply 1500 (comes from supply method analysis) by average gross margin we may have third number for sales. 15000 * (1+ 0.3147) = 19721. All three numbers are very close to each 20010, 20243 and 19721. It seems like trader gave correct information. For Sales and COGS in the CF let us take something in the middle. Sales 20000 and COGS 15200.

Operational expenses

PO has to ask about operational expenses. These could be salaries of workers, utilities, transport, food, rent, and others. When asking about operational expenses PO has to be careful. For example PO knows that trader goes to 3 main markets (A,B and C) 9 times a month. Transportation expenses should include these expenditures as well. PO has to ask weather workers bring their food or it is provided by trader. Is the shop belongs to trader or is it rented? Utilities may include water, phones, electricity, etc. Are there any specific expenditure? For convenience let us assume that operational expenses are 2000.

Taxes

PO has to check what kinds of taxes are paid and ask to show the receipts. If trader has overdue taxes PO has to ask why. It may mean something bad regarding responsibility and honesty of trader. If trader is not punctual with payment of taxes, it is risky to invest money to his business, because there is a risk that tax authorities may apply financial punishments to him. Let us assume that monthly tax is 800, which means net cash flow will be 2000.

Sales 20000 – COGS 15200 – Operational expenses 2000 – Tax 800 = Net cash flow 2000.

Table-4

Sales	20 000
Cost of Goods Sold (COGS)	15 200
Gross cash flow	4 800
Operational expenses (total)	2 000
Taxes	800
Net Cash flow	2 000

5.4.2 Balance sheet (BS)

We need to see the financial structure of a business for the date when PO is doing the analysis. Therefore BS is important. It explains the sources of the funds and usage of funds in a business. Also BS will be used to determine PLS ratio. Following table could be helpful for PO to compile BS.

Table-5

Assets		Liabilities	
Current Assets (Total)		**Short Term** Liabilities	
Cash at Hand		Supplier Credit	
Money in Bank		Loans up to 4 months	
Receivables		Others	
Inventory		Long Term Liabilities	
Others			
Fixed Assets (Total)		**Equity**	
Real estate			
Equipment			
Vehicles			
Total Assets		**Total Liabilities + Equity**	

Assets could be physical items, money or rights to physical items or money. To be included into the BS, fixed and current assets should be in use for business. All assets that are not used in business are not included in the BS. Moreover, assets should belong to entrepreneur. All assets should be assessed according to the market value.

Since PO cannot see liabilities, he should ask every detail about them. It could some funds that needed to be repaid to suppliers. It could be a loan from the bank.

5.4.3 Determination of PLS ratio

Let us assume that the value of the business (total assets) is 24000. Entrepreneur wants another 6000 for business and wants to repay it in 6 months. After financing, the total value of the business will become 30000. Loss sharing ratio will be 20% for FI and 80% for the entrepreneur. It means that, if after financing the project, the business suffers loss; the FI will share 20% of it. What about profit sharing ratio? Does 20% share in the value of the business means that FI entitled for 20% of profit? Maybe yes maybe no. It depends on agreement between parties. But, 20% is the point from which **bargain** between parties will start. FI has right to request 20% because FI shares 20% of the loss. PO may say: I analyzed your business and you have several risks 20% of which will be borne by FI. In turn, entrepreneur may say that he already took measure to secure the risks. And therefore FI should give discount. Each parties give own arguments for decreasing or increasing the ratio. The argument of FI is the existence of risks, and argument for entrepreneur is how well he can control those risks, or how hard he works to prevent the risks. Let us assume that for profit sharing ratio, they agreed on 10% to 90% for FI and entrepreneur accordingly.

5.4.4 Determination of investment capacity and investment period

PO already knows that *net cash flow* is 2000 (*Table-4*). Profit sharing ratio is 10% for FI. It means that remaining 90% or 1800 is for entrepreneur. Does this mean that entrepreneur may repay 1800 each month? No. Entrepreneur will need money for family. If the entrepreneur is the main bread-winner then the needed money should be deducted. For example, he will need 1000 to support family expenses. It means that he may repay only 800 per month which is *conservative net cash flow*. Now PO has to check if remaining 800 is enough to repay the debt in 6 months. 6000 / 6 months = 1000. It means that, to repay the debt in 6 months 1000 is needed, but we determined that *conservative net cash flow* is 800 not 1000. There are 3 solutions for this situation.

Solution 1. Set longer period. For example 8 months. (6000 / 800 = 7.5)

Solution 2. Decrease the amount of the investment till 4800. (800 * 6 = 4800)

Solution 3. Entrepreneur has to prove that family has more incomes a part of which will support family. For example wife of entrepreneur is working as a teacher and her salary is for example 750. Entrepreneur has to show records of hers official salary. Or, maybe his son is doing own business. In this case PO has to make analysis of that business also. Otherwise it may not be accounted as additional profit. Even, it is permissible if entrepreneur wants to use his entire share part for repayment the debt, if other incomes of the family very enough to cover all the family expenses. Entrepreneur may want to do so in order shorten the *investment period* or increase *investment capacity*.

Let us assume that entrepreneur proved that his wife is working and 200 of her salary will be contributed for family expenses. Now, CF looks like this:

Table-6

Sales	20 000
Cost of Goods Sold (COGS)	15 200
Gross cash flow	4 800
Operational expenses (total)	2 000
Taxes	800
Net Cash flow	2 000
Conservative net cash flow	1 000

Net cash flow is expected profit of the business which will be shared with between entrepreneur and FI. *Conservative net cash flow* is assumed profit which entrepreneur should be able to repay, hence it determines maturity date of the project.

Since the profit of the business is not fixed and not guaranteed, for both of the parties usage of *conservative net cash flow* is beneficial. If for example *net cash flow* is taken into account, and if profit decreases a little, then entrepreneur will not be able repay debt according to the schedule. Thus, his reputation becomes bad. On the other hand, not following schedule is not preferable for PO as well. Because it will mean that in his portfolio there is overdue debt. Thus, his bonus will be less for that period.

SECTION 5.5 DETERMINATION OF SECRET NUMBER AND REPAYMENT SCHEDULE

Secret number is needed for monitoring. We already know that profit share of the FI is 10% or 200. Also we aware that profit of the business is not fixed. It may be less or more.

Now assume that money will be spent to buy furniture for the shop. It means that the turnover of the business will not be changed, thus profit for following month will remain about the same, a bit less than 200 or more than 200. But if money was spent for replenishment of working capital, then it means that turnover should increase. Since it is used to increase capital, as an idea profit of the business should not be less than 200.

Now, PO has to ask about seasonality of the business. The question to be asked to the entrepreneur is: According to your experience, how the business may change for next 6 months? If the date of analysis is March, is there any seasonal issue that may affect business during April, May, June, July, August and September. To help entrepreneur to answer the question we may ask another question: Considering March as 100% of performance, what percent will be on next 6 months?

Assume that the answer was following: April and May is same 100%, June and July 90%, August and September is the same 100%.

Month	April	May	June	July	August	September
Seasonality	100%	100%	90%	90%	90%	90%

Profit sharing ratio = 10% for FI
Investment = 6000
Maturity = 6 month
Repayment = 1000 monthly

Now we have to see how much will be profit share rate of FI after each repayment. Repayment of debt is 1000 each month during 6 months. Since repayment is 1000 units each 6 times, the easiest way is to divide 10% by 6. It means that after first repayment the share of the FI will decrease to 8.33% from 10%. Each time after repayment ownership share of FI decreases by 1.667. Now we have following picture.

Table-7

If money was spent to buy furniture					
Month	Remaining debt	Profit sharing ratio	Expected profit for FI (decreases 1.66% each time)	Seasonality	**Secret number (d * e)**
a	b	c	d	e	f
April	6000	10.00%	200	100%	More or less than **200**
May	5000	8.333%	166.66	100%	More or less than **166.66**
June	4000	6.666%	133.33	90%	More or less than **120**
July	3000	4.999%	100.00	90%	More or less than **90**
August	2000	3.333%	66.67	100%	More or less than **66.67**
September	1000	1.667 %	33.33	100%	More or less than **33.33**

In *Table-7* we assumed that money was used to by furniture for the shop. It means that turnover is not changed, thus secret number contains word **more or less**. This shows approximately how much of profit FI has to receive. Entrepreneur should not know *secret number*. But entrepreneur should know what will be profit sharing rate for next month.

Let us assume another situation when money was used replenishment of working capital. For example with received funds, trader became able to sell more products than before. Consequently, the profit of the business should be more, or at least it should not be less.

Table-8

If money was spent for replenishment of working capital					
Month	Remaining debt	Profit sharing ratio	Expected profit for FI (decreases 1.66% each time)	Seasonality	**Secret number (d * e)**
a	b	c	d	e	f
April	6000	10.00%	200	100%	More than **200**
May	5000	8.333%	166.66	100%	More than **166.66**
June	4000	6.666%	133.33	90%	More than **120**
July	3000	4.999%	100.00	90%	More than **90**
August	2000	3.333%	66.67	100%	More than **66.67**
September	1000	1.667 %	33.33	100%	More than **33.33**

In this case money was spent for replenishment of working capital. This means that turnover of entrepreneur should increase a little. Therefore *secret number* contains word *more than*. If paid by entrepreneur share to FI is not more than the secret number, it likely that entrepreneur is cheating. Entrepreneur has to have exact reasons to prove that the number is real. PO should talk to entrepreneur very seriously and explain that if he cannot maintain business profitability as it was in the beginning, then FI will not issue another financing to him. Moreover, his history will be entered to the software so that every FI will know that he is not reliable entrepreneur. However, if there is a real reason, then entrepreneur has to prove why business was not so profitable for last period. If the reason is not satisfactory, then probably entrepreneur is cheating.

SECTION 5.6 REMUNERATION OF PROJECT OFFICERS

Salary and bonus payment method is an integral component of the model. In order to stimulate POs, the model proposes performance based remuneration.

5.6.1 Remuneration during training period

Training period is the period when after hiring PO, FI teaches them on all the procedures. Based on the learning performance of the trainees, FI decides whether he or she is suitable to continue working. In other words it is probation period.

At this period FI has to provide trainees with fixed allowance to cover their expenses for food and transportation. This is the first step to stimulate potential POs. Because when trainee sees that organization they are training in is supporting them financially even though they are not hired yet, they begin to understand that it is serious organization for which they will have to struggle.

5.6.2 Remuneration during Musharakah period

Those who passes probation period become project officer. At this period PO does not have own portfolio yet, therefore it is not possible to assess contribution of PO. At this period FI has to provide PO with fixed salary and a bonus for each financed project. Fixed salary is always unchanged, but bonus will depend on how many *Musharakah partners* could find PO. For example, PO was able to finance 5 projects during first month. FI will pay $5 per each project which is $50 it total. This is called *bonus per project*. If PO has overdue payment in his portfolio, then FI should penalize PO for not taking measures against overdue payments. For example one of entrepreneurs did not repay debt (not profit share) without any reasons. In this case FI will deduct X% from the bonus of the PO. Each FI is free to decide own penalty rate for such cases.

5.6.3 Remuneration during Musharakah and Mudharabah period

In second period, in addition to main fixed salary, PO will continue receiving bonus per project. But during second period, only Mudhrabah projects will be counted.

*Musharakah project*s are already yielding profits. PO starts receiving bonus, amount of which depends on the amount of profit received from his portfolio. For example, during first period certain PO was able to finance 10 *Musharakah project*s. FI received $500 profit from these 10 projects. FI will pay 3 % from the $500 to PO as bonus. It means PO receives $15 as bonus. Thus, each PO has a strong incentive to grow the number and volume of partners in his portfolio. At the same time PO has incentive to strictly monitor each partner, because if they start cheating and pay very small profit, it will negatively affect his bonus. This bonus is called *performance based bonus*.

5.6.4 Remuneration after pilot period

After pilot period is over, *bonus per project* will not be paid anymore. Only fixed salary and *performance based bonus* will be paid to PO.

CHAPTER 6. CONCLUSION

6.1 Introduction

There are thousands of publications in business magazines, journals and internet concerning trends in Islamic finance. Nowadays, even largest banks like HSBC and Deutsche bank that are based in non Islamic countries are joining this nontraditional financial market. Moreover, in European countries like UK and Switzerland, Islamic Financial Institutions (IFI) are already established and very well operating, while number of new institutions is growing constantly. Japanese financial institutions are making a late entry into the Islamic financial world compared with Western counterparts; nonetheless, they appear to be warming up rapidly. Nevertheless, not all the publications concerning this growing industry are positive. Many Islamic scholars and observers are uttering negative opinions in address of IFIs for being not compliant with Shariah rules. Some of them even hinting out that in financial industry word "Islamic" became something like new brand that attracts people with religious believes. Most of the criticisms are related to the fact that Islamic Banks are not actually applying financial products that are based on profit and loss sharing (PLS) principles. However, many believe that the very distinguishing feature of Islamic bank is sharing of profits and losses with its customers.

6.1.1 Initial aim of the research

I was aware of such critical situation regarding misapplication of PLS based products. Also I was aware that Islamic microfinance industry is even less developed in the terms of providing PLS based services. Since my work experience was mostly related to financing micro and small enterprises (MSE), attention mainly was focused on issues related to Islamic microfinance (IMF). For some time I pondered on about applying my ideas for MSE financing projects. When I find out that IMF industry is just emerging market niche, the decision was to take challenge and try to apply my own ideas for this niche. Short research into IMF showed that just as Islamic banks, IMF institutions also mainly providing financial services by not sharing profits and losses. The reason for this is very simple; lending money on the principles of PLS is extremely risky operation. The decision was to develop financial product which will be based on PLS principles, will be easy to apply, and could be used to finance MSEs. In other words, I wanted to create financial product and contribute to microfinance industry. With this initial aim the research was started. To fulfill the aim of the research, the objectives were designed for learning Islamic Financial Jurisprudence.

6.1.2 The aim and objectives have changed

However, when qualitative research was accomplished, I realized that the aim of the research is not so correct. Surprisingly, I figured out that the issue is not related to absence of PLS based financial products, but it is more related to inability of utilization of such products. Because of high risk in application, FIs just avoid sharing profit and losses, which is quite justified situation. At this point, the aim of the research has shifted from creating a product to developing of a model of application. Accordingly to this aim, the objectives also were changed as described in section-1.3. Shortly, the objectives are: a) find a problem, b) identify the cause of the problem and c) develop and propose solutions.

6.1.3 Problems are recognized

In CHAPTER-3, research identifies that two financial products that are based on PLS principles are *Musharakah* and *Mudharabah.* Sometimes they are referred as "instruments", as "products" and classified as *natural uncertainty contracts*. Business financed on the basis of these instruments called *Musharakah project* or *Mudharabah project,* and entrepreneur becomes *Musharakah partner* or *Mudharabah partner.* Shortly, *Musharakah* operation is something like joint-venture operation, where financier and entrepreneur invest sources to do business and share profits and losses from that operation. *Mudharabah* is quite similar, but in this case entrepreneur invests labor and knowledge while all the financial investment is done by financier only. Instruments could be applied for both single transaction as well as large business project. Sections 3.3.2 and 3.3.2 provide detailed theoretical information about *Musharakah* and *Mudharabah.* Practical application of these instruments described in the form of small cases in sections 4.3.2 and 4.3.3. Research proved that these instruments are utilized very poorly. In the case of Malaysia we can see that on March 2010 only 2.31 percent of financings issued by Islamic banks are based on these two instruments. The rest of financings are not PLS contracts while many believe that the main distinguishing feature of Islamic finance should be sharing of losses and profits. After the problems are identified, next question to answer was: Why IFIs are avoiding utilization of *Musharakah* and *Mudharabah?*

6.1.4 The sources of the problems are recognized

CHAPTER-4 provides detailed information on the problematic factors in utilization of *Musharakah* and *Mudharabah* in practice. The provided information is mainly based on results of interview conducted with two experts from Islamic commercial bank and one from microfinance bank. They all possess deep knowledge in their fields and familiar with practical issues better than theoretical. Sections 4.3.4 and 4.4.1 provide detailed information about the interview. In addition to interview, the report published by Islamic Research and Training Institute (IRTI) a member of the Islamic Development Bank was quite useful.

As a result of literature review and qualitative research, in application of *Musharakah* and *Mudharabah*, following problems were determined:

1) Many entrepreneurs are not able to provide sufficient collateral to secure the debt.
2) It is not easy to assess financial statement of entrepreneurs because most of them do not keep the books.
3) It is difficult to determine the ratios for sharing profits and losses.
4) Entrepreneurs received financing from the bank may have inclination to under declare profit in order to pay less than required.
5) Because of uncertainty concerning future profits of the businesses it becomes necessary constantly perform monitoring and even revisions to the business. It means monitoring of the projects increases administration expenses.
6) Because of huge amount of time spent to monitor the projects, officers do not have enough time to conduct marketing and find more potential partners.

7) Even in the hypothetical situation that profits are known, the borrower has to repay a different amount each period and the loan officer has to collect a different amount each period. This lack of simplicity, relative to equal repayment installments, is a source of confusion for borrowers and loan officers.

8) Stimulation of both bank workers and entrepreneurs also needs attention.

Interviewees got familiar with my proposals addressed to solve the problems. Basically, they all expressed positive attitude to the idea and suggested some more comments to make it better.

After the problem is known and the source of the problem is determined, it is time to approach the main aim of the research. As it is mentioned before, the aim is to develop a **model for implementation of MSE financing products that are based on PLS principles.** I decided that the model should be developed in the form of manual for MFIs.

6.2 The Model

To apply *Musharakah* and *Mudharabah* successfully, there must be specific strategy. The strategy should be addressed to solve each of eight determined problems, while each function within the model should be interlinked. There must be a strong link between each party, which supports and at the same time controls each other. In another words, each party has to have incentive to do a good job at the same time provide incentive to other party. Who are the parties? One is project officer (PO) that deals directly with entrepreneurs. Second is entrepreneur who wishes to obtain funds for his business. The third is FI that searches profitable investment opportunities. But just providing salary-based incentives to POs is not enough. POs need to have knowledge on how to find a potential entrepreneur, how to analyze the business, how to perform control over financed projects and how convince entrepreneur to work honestly.

CHAPTER- 5 includes a manual which proposes a model with solutions for the problems. However, let us make small overview.

6.2.1 General idea and structure of the model

Shortly, the model proposes 1 year pilot phase which consists of two periods. During the first period only Musharakah contracts will be financed and during second period both *Musharakah* and *Mudharabah* will be applied. The idea of such strategy is to start with relatively less risky projects and then continue with more risky projects. CHAPTER-5 explains the model in detail, but here are some particular features of proposed model.

6.2.3 Goal and mission

The model has a goal and a mission. Goal is to determine potential partners and expand investment portfolio. Mission is to constantly observe and analyse the situation in the market and collect information. The collected information should help to:

a) Find out the types of businesses that promise to be relatively more profitable and stable.
b) Determine people who could possibly become potential partners.
c) Be aware of possible changes in the economy or market that may negatively and positively affect investment portfolio.

6.2.4 First period

During first period the target entrepreneurs are the ones who already running a business. It is relatively risky because existing business is easier to analyze and usually owners of such business are able to provide sufficient collateral. During dealings with *Musharakah* partners PO will have a great opportunity to collect strategic information about future opportunities in the market. For instance, in the example of *Musharakah* projects, PO will learn what type of businesses is more stable and profitable. *Musharakah* partners could become a source of valuable information about other reputable entrepreneurs who may become a partner for FI. Overall, strategic information collected during first period should help to define investment opportunities for *Mudharabah* financing.

6.2.5 Second period

Second period starts with first financing of *Mudharabah project*. *Mudharabah project* is more risky for FI, because entrepreneur will not bear financial risk, since FI is the owner of the project.

6.3 TOOLS AND INSTRUMENTS PROPOSED IN THE MODEL

As it listed above, there are mainly 8 problems faced by FI in applying *Musharakah* and *Mudharabah*. The model proposes solution for each of them.

6.3.1 Collateral (problem-1)

Section 5.2.11 explains a unique method for securing projects. According to it, primary factors of security are ability to repay, willingness to repay and level of the risks. Collateral is playing secondary role, and main aim of collateral is just to use it as moral inducement tool against not honest entrepreneurs.

6.3.2 Analysis and ratio determination (problems 2 and 3)

Sections **5.2.6** and **5.2.7** are proposing solution for problem-2 which is related to the difficulty of business analysis. With this method, PO will be able to assess financial situation even there is no bookkeeping in the business. Moreover, this method of analysis helps to figure out whether entrepreneur is cheating or not by doing cross-checks of numbers. The method is not new, however I made some KAIZEN by adding the concept of *conservative net cash flow* (section **5.4.4**). It is an instrument with which PO may determine not just financial capacity but the very amount which entrepreneur will be able to repay without doubt. Hence, there will be no overdue payments in the portfolio of the FI. At the same time, entrepreneur will have more chance to repay debt exactly according to the repayment schedule. It means entrepreneur proves to be a reputable person and increases chances to have constant access for financial support.

The solution for determination of PLS ratios which is based on **bargaining method**, is explained in section **5.2.8** (for *Musharakah*) and **5.3.6** (for *Mudharabah*).

6.3.3 Uncertainty and Monitoring (problems 4, 5 and 6)

The biggest obstacle in PLS based financing is uncertainty in the future profits. Therefore it requires constant monitoring of the financed projects which takes a lot of time. Time is money. The model proposes an instrument for forecasting future period profits and instruments to decrease time spent for monitoring. I have developed an instrument called a *secret number* (section **5.2.15** and **5.5**) which suppose to help to maximally determine whether partner is repaying a due amount of profit. Also I proposed another concept called *calculation report* (sections **5.12.15)** which will help to save time for both partner and PO. *Calculation report* is small manual for entrepreneur which shows how to calculate profits and losses and determine how much to pay to FI.

6.3.4 Stimulation strategy (problem-8)

For FI, in order to be profitable, it is very important to increase the volume and quality of loan portfolio. But it may never be reached if there are no incentives for all 3 parties (section-**6.2**). The model proposes *performance based* remuneration system (section **5.6**) which motivates PO to work fast and carefully. The instrument named *graduation principle* (section **5.2.15**) is there which motivates entrepreneurs to work duly without any cheatings.

For example if PO want to have high bonus, he will have to search for potential partners/entrepreneurs and build up own portfolio. But if PO performs poor analysis and issues financing to risky projects, it may negatively affect his portfolio thus his bonus will decrease. Hence, PO has incentive to work faster and better. On the other hand, an entrepreneur may have desire to under declare the profits in order to keep more profit for himself, but by doing so level of investment capacity of his business will decline and he will not be able to receive needed money. But, if the entrepreneur starts to under declare profits <u>after</u> receiving funds, then he has to be aware that *graduation principle* will not be applied to him. It means for the next time there will be no chance to receive financial support. Hence, entrepreneur has incentive honestly and repay duly. In this way all three parties are interlinked.

6.4 CONTRIBUTION TO THE KNOWLEDGE AND RECOMMENDATIONS.

As it is mentioned in the research, the market for Islamic microfinance is untapped market. It is not already a secret that in many countries entrepreneurs reject interest based loans referring to religious believes. At the same time the Islamic microfinance industry it its earliest infancy phase. In addition to this, even in few established MFIs the application of *Musharakah* and *Mudharabah* is avoided. It is evident that the research has a good value.

When I was developing a model, I tried to combine my skills obtained in the near past, my new ideas and findings of the research. Surely, I have a feeling that my model could be useful and successful. However I understand such opinion may not be proved unless not tested.

I tried to consider existing issues from a different angle, not from the financier's part nether from entrepreneur's. But more likely from the point of view of Consultant that understands the situation and eager to provide solution advantageous for both. **In larger scale**, my intension was not to contribute only to IMF industry but to create an **alternative method** of financing MSEs that could be utilized in different parts of the worlds.

In order to be utilized effectively, I will send CHAPTER-5 of this research to several financial institutions in several different countries that are involved in financing micro, small and medium entrepreneurship.

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DEFINITIONS

IFI	- Islamic Financial Institution
MSE	- Micro and small enterprises
PLS	- profit and loss sharing
FI	- Financial institution
IDLO	- International Development Law Organisation
IRTI	- Islamic Research and Training Institute (IRTI)
IMF	- Islamic microfinance
PO	- Project officer. Something like loan officer in conventional banks
SCA	- Shariah-compliant assets
CGAP	- Consultative Group to Assist the Poor
Investment portfolio	- Something like loan portfolio in conventional banks
Mudharabah	- A partnership arrangement in which one party provides capital to the partnership while the other party provides entrepreneurial skills. Any loss is borne by the financier; any profit is shared by the partners according to a pre-agreed ratio
Musharakah	- Literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture
Musharakah partner	- An entrepreneur that received funds according to the terms of Musharakah. Something like borrower in conventional bank
Mudharabah partner	- An entrepreneur that received funds according to the terms of Mudharabah. Something like borrower in conventional bank
Potential partner	- Any entrepreneur who is likely to become a partner (customer) to FI.